RAPID ASSESSMENT REPORT

HOUSING FINANCE POLICY STRATEGIES FOR POLAND

Prepared for

USAID

East European Regional Housing Sector Assistance Project
Project 180-0034
U.S. Agency for International Development, ENI/EEUD/UDH
Contract No. EPE-C-00-95-001100-00, RFS No. 648

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July 1998
UI Project 06610-648

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1. EXECUTIVE SUMMARY AND OVERVIEW

Introduction

The goal of this paper is to provide USAID with a review of public sector housing finance policies in Poland in order that they may be in a better position to assess the need for technical assistance and cooperation.

A major analysis of public sector housing finance policies was recently completed by the Housing and Urban Development Authority (HUDA), resulting in a comprehensive document entitled “Town and Country Planning, Real Estate, and Housing Construction: Medium-Term Strategy for the Industry,” Warsaw, April 1998 (hereafter referred to as the HUDA Strategy Report). This compendium reviews a wide variety of housing, infrastructure, and utility policies, including tax and legal issues, from the perspective of central government policy reform actions and support to gmina policies.

A housing finance team from the Urban Institute Consortium, which undertakes USAID’s Poland Housing Finance Project, has reviewed those portions of the HUDA Strategy Report which focus on public sector housing finance policies, especially where the central government has the predominant role, or a strong supporting role with the gminas or other levels of government. This report is based on our review of the HUDA Strategy Paper and discussions with HUDA officials, other government institutions, and other housing experts in Poland during late June 1998. During these interviews the team sought to clarify its understanding of the proposed housing finance policies and to discuss options, goals, and strategies. We have attempted to provide USAID with advice on the types of donor-supported technical assistance which the Government of Poland (GOP) might utilize in continuing to formulate and carry out its strategies. This Rapid Assessment Report is being provided within a few weeks of the team’s visit. A final report, which will contain additional analyses as well as responses to suggestions by USAID and HUDA, will be available in the fall.

USAID’s urban program in Poland currently involves multiple projects and contractors, including the Local Government Partnership Program (LGPP) and projects undertaken by the Cooperative Housing Foundation (CHF). The vast majority of these efforts are being carried out at the gmina level and involve gmina planning and financial strategies for housing, infrastructure, and broader economic development activities. In contrast, the UIC Housing Finance Project operates largely at the central level with counterparts including the Ministry of Finance, the National Bank of Poland, and the Polish Bank Association, in addition to the Housing and Urban Development authority.

The Housing Finance Project was initiated in November 1996, when USAID sponsored a broad-based review of housing finance activities in Poland. The resulting report—*Building on Progress: the Future of Housing Finance in Poland*—has been widely distributed in Polish and English (hereafter referred to as the Assessment Report). In addition, the Report's topics, which include both private and public sector housing finance, were discussed at a conference in April 1997. Currently, the Housing Finance Project is working on, or has recently completed, a number of studies with a direct bearing on the topics to be addressed in this statement of work. These include analysis and training system development with regard to Poland's proposed mortgage banking system, and analyses of the Bausparkassen system, the problems posed by the statutory lien, and current status of rent reform policies and housing allowance participation. Finally, the UIC team is familiar with efforts in housing finance undertaken by the British Know How Fund (BKHF), the European Union, and the German Banks Association. The recommendations for technical assistance presented in this report are designed to complement or supplement these multiple ongoing efforts.

The HUDA Strategy Report and Priorities for the Housing Sector

The HUDA Strategy Report is a major accomplishment: a comprehensive review of housing and urban problems and issues and a compendium of the institutional responsibilities and the proposed strategies and actions needed to address the concerns.

Overall, the UIC team finds the HUDA Strategy Report, together with the additional information provided by our discussions with HUDA and other officials, and the supplementary documents provided to us by HUDA (further detailing certain strategies), to be a thorough and valuable guide to the development of housing policies in Poland. HUDA has structured its approach in a manner consistent with the "enabling strategy approach" to the role of the central government that has formed the basis of USAID's approach to housing sector development. As stated in the Introduction of the HUDA Strategy "[*the] role of the State in economic processes with regard to real estate and housing should be restricted – the State should promote competitiveness and limit its interference to a minimum. The most fundamental task in this area should be providing a balance between the production sector and the consumers (landlords and* *tenants), especially in such cases where due to social or economic reasons free market mechanisms fail to operate*;...".

Thus, the recommendations and critiques which follow must be viewed in the context of overall approval of the large majority of HUDA's policy suggestions; we have attempted to assist HUDA in making its strategies and recommendations more fully integrated, internally consistent, and more operational. Our suggestions have attempted to undertake the following:

- To further clarify the needs and resultant goals for the housing sector.

- To develop internal consistency among important proposals, such as those for rent reform and housing allowances; the role of BGK, the NHF, and the proposed Renovation Credit system; and between the two contract savings systems.

- To provide a clearer notion of the priorities—so that limited government funds can be more effectively targeted.

- To assist in further development of strategies that are, at present, more general concepts than operational programs.

A Framework for Housing Sector Development and Principles of Subsidy Design

The HUDA Strategy details many issues and suggests the expansion of many existing programs and the creation of a number of new programs. However, while HUDA clearly expresses many ideas for policy reform, and makes many suggestions to ameliorate constraints to both demand and supply in the housing market, there is no mechanism suggested for prioritizing the issues and programs. Furthermore, there is little analysis of the costs of many of the programs; given better cost estimates, which could then be compared with the likely level of state funds available, a clearer sense of priorities would have been established.

Underlying HUDA's proposals is an assumption that there is an extremely large shortage of housing in Poland. Various estimates of the shortage have been made; they are generally based on an analytical methodology which compares the number of households and the number of existing housing units (both now and/or a decade or more into the future). This approach to estimating housing needs—although it may be generally illustrative of a housing problem—is not especially useful for designing a subsidy program. The real economic cost of housing is high, and nothing can change that fact no matter how the housing is paid for. Poland (and most other countries in the world) cannot "afford", in the near future, to build the number of housing units yielded by these various estimates of the excess of households (existing now or to be newly formed) over acceptable dwellings. Rather, the definition of "need" for the purposes of program design must be defined in terms of affordability and a realistic assessment of both private and state resources available in the short and medium term. In this manner, priorities can be better established.

In this context, Section 2 of this report proposes a general framework that might help prioritize the programs and initiatives. The major elements of the framework include:

- The pressing need for market rents (combined with a supportive housing allowance program).
- An improved legal and regulatory framework.
- The urgency of achieving macro-economic stability and lower interest rates; the increased mobilization of private resources for housing.

The framework assists, in a general manner, in establishing program priorities. To address issues of affordability, cost, and alternative approaches to subsidies and funding, additional issues—from a program design standpoint—include the following:

- What would be the extent of the affordability problem for households in Poland if there were no assistance from the state? This type of estimate serves as a "baseline" from which to quantify housing goals from an affordability perspective.
- Given that the state wishes to help solve the problem of affordable housing (a difficult problem in every country in the world), to what extent do different elements of the housing stock and different income groups need to be assisted, consistent with some "reasonable" goal of funding from central and gmina budgets.
- What policies elicit the maximum contribution of resources from households and the private sector in general.

- What is a “fair” share of the burden that should be borne by households in different circumstances (different incomes, owners versus tenants, newly privatized housing, and so forth).

- What policies implement the “redistribution” of income most fairly and cost-effectively—that is, which are well-targeted and do not generally subsidize those who can pay are clearly understood and deemed “fair” (transparency); are administratively most efficient; and, if regressive (rather than progressive) are justifiable in supporting an important and clear policy goal.

- What policies work best in conjunction with the private sector—that is, do not undertake to do what the private sector will do on its own, do not “compete” with market interest rates and market mechanisms (such as commercial loans or the incipient municipal bond market), thereby not undermining the development of commercial finance for households, gminas, and developers.

- What subsidy tools most efficiently accomplish specified goals—preferential loans, tax benefits, grants, block grants, and so forth?

Based on the “market development framework” and on the issues involved in subsidy design summarized above, we have attempted to critique and prioritize HUDA’s housing finance recommendations. Our proposals are summarized below and presented in more detail in Sections 4 through 7. In addition, Section 3 discusses the state budget for housing and provides preliminary suggestions for addressing the budgetary legacy of the old housing programs.

Overview of Recommendations and Proposals for Technical Assistance

Our recommendation with regard to topics in public sector housing finance and our suggestions for technical assistance are described below. As noted above, by and large, the team is in agreement with many of the proposals put forth by HUDA. However, we have established certain priorities in the policies which imply a somewhat different allocation of funds than HUDA might undertake.

Table 1 summarizes the key HUDA proposals we have reviewed, HUDA’s recommendations, the team’s comments, and some elements of the proposed technical assistance. Our proposals and our modifications to HUDA’s approach are summarized as follows:

- **Rent Reform.** HUDA's Strategy Report clearly states that rent reform is important. The team feels that rent reform is absolutely crucial to development of a market-based housing sector and should be the very first priority. It is probable, however, that the central government will have to develop a more effective approach to ensuring that rent reform actually takes place as soon as possible. This could be done either through legislation concerning rents or by providing some "carrot and stick" incentive policies to ensure that reluctant gminas—which describes nearly all of them—actually undertake the necessary increases and restructuring.

- **Housing Allowance Reform.** HUDA is also clear that reform of the housing allowance program is necessary to support rent reform. We concur; we suggest, however, a number of alternative parameters for reform. First and foremost, the formula used to improve the allowance program should be tied to the rent policy reform goals, rather than to more arbitrary income ceilings that pertain to pension policy. In this fashion, affordability would be ensured as rents move toward their replacement cost target. It is also proposed that households gradually begin to pay a higher share of the housing cost, more in line with payment burdens now in place in the U.S., Western Europe, and elsewhere.

- **Fiscal Incentives for New Construction.** HUDA has proposed returning to the 1996 approach to the tax incentives for new construction, which is far more generous that the current (1997) approach. While the team concurs that tax relief policies which affect the highest income households may be an efficient method for increasing the housing supply, we feel that the current level of benefits is a sufficient incentive. The previous tax relief program was very expensive and is, of course, a highly regressive policy. The funds saved (in that less tax revenue would be foregone) could be more usefully spent on other housing policies (allowances and rehabilitation, for example). In addition, we predict that, on the margin, there would be little difference between the two programs' desired impact on new housing starts. Finally, once such generous tax benefit systems have been put in place, it is generally difficult to alter or eliminate them, as is so well demonstrated by the generous and regressive tax policy for housing in the U.S.

- **Rehabilitation.** In the team's view, rehabilitation should receive far more attention than it has in the past. The various estimates of rehabilitation, whatever their differences, all indicate that the problem is simply immense. However, there are almost no policies or funding in place to deal with the most important and most straightforward of the rehabilitation problems: the capital backlog needs of major building systems. (Nor are policies in place to address so-called complex revitalization, although it has been discussed at length; see Section 5). The team suggests that the capital repairs backlog in communal and newly privatized housing is a national legacy which the central government must share in redressing; it is beyond the reach of almost all households, but must be addressed quickly as a vital part of maintaining Poland's housing supply. HUDA has proposed a Renovation Credit System, but this was noted by many officials to be "just a concept" at this stage. It would be advisable to operationalize this concept, and/or alternatives, and to seek funding as soon as possible.

- **Social Housing and Homelessness.** The HUDA Report also addresses the increasing problem of homelessness and special needs, and has suggested that state funds be allocated (and that the building code be relaxed) for building "social" housing. In general, the team does not recommend the use of scarce state resources in this manner—that is, building new "substandard" or special housing; it is preferable to utilize existing housing, modifying it as required, rather than increasing supply for a segment of the market which has few funds and which should be supported through housing allowances. These households should utilize housing allowances in conjunction with whatever other social safety net funds they are eligible to receive.

- **Strengthening Private Sector Finance and Public Access to Private Capital and the Banking Sector.** As noted above, the UIC team has been undertaking a variety of training and technical assistance activities designed to strengthen private sector finance. Section 6 of this report discusses additional assistance with regard to the contract savings system and the Bausparkassen, the Act on Mortgage Banking, the mortgage fund, and the mortgage banking proposal of the so-called Group of 12. In addition, we have made a proposal to assist the government adjust the payment structure for the debts from the "old policies". We also support increased efforts to enable the public sector to access private funds from the capital market, such as the issuance of bonds by BGK to fund National Housing Fund activities and the strengthening of TBS to attract private capital.

- **Enabling Strategy Issues.** The HUDA report provides recommendations regarding a wide variety of legal and administrative "enabling" strategies, including the statutory lien, condominium and housing association issues, mobility within the housing stock, eviction, title registry, and so forth. USAID and other donors are assisting with a number of these important issues and we encourage HUDA to continue its emphasis on these enabling issues. The UIC team is currently working on a study of the statutory lien, which draws on progress made in other Central European countries. In addition, because of our emphasis on the importance of rehabilitation, and the constraints to rehabilitation caused by mixed ownership patterns and weaknesses in wspolnota (housing associations), we place particular priority on improved privatization strategies, development of condominium associations, and strengthening of building association management. These issues can also benefit from a cross-regional assessment of best practices.

A Four-Tier Approach to Technical Assistance

As noted above, both USAID and other donors are very actively engaged in supporting local government and assistance to the housing sector in Poland. Our proposals are designed to be integrated with, and supplement these efforts. Much of the technical assistance is being delivered at the gmina level; our proposals also suggest additional technical assistance to HUDA, other central government institutions, and banking sector institutions in order to (1) provide needed regulation and incentives at the central level; (2) more fully develop and operationalize the high priority programs; and (3) further engage private funds in housing (and infrastructure) development.

Thus, we propose a four-tier approach to technical assistance:

- Assistance with further development of key strategies at the central level.

- A variety of gmina-based programs, such as pilot projects and dissemination of best practice case studies.

- A combined powiat (or voivod) and gmina demonstration pilot to test a combination of necessarily integrated strategies: rent reform, housing allowance reform, and rehabilitation strategies, for example.

- Assistance to the private sector housing finance institutions, the banking sector, BGK, and other financial sector institutions as relevant.

Technical Assistance for Central Government Policy Making

Although the main responsibility for housing rests with gminas, without central government leadership in key areas, certain gmina policies cannot be as effective as they should (or could) be. This includes rent and housing allowance policies, rehabilitation strategies, and enabling framework strategies at a minimum. Recent re-thinking of the role of liberalized government in transition countries remains in accord with reducing the size of central government and eliminating its direct provision of services; however, the mandate for central regulation and policy guidance is viewed as increasingly critical. In Poland's case, for example, it is difficult for an individual gmina to overcome political opposition to increasing rents; from a national perspective, however, such an action by all gminas would ultimately produce a very large economic benefit. As another example, the history of subsidized rental housing programs in the U.S. and Europe provides many (often painful and costly) lessons learned; if enthusiasm for TBS-type projects overtakes the organizational, monitoring, and long-term planning functions that must support them, failed projects could doom efforts to attract private capital. Thus, central government must design, implement, regulate, and enforce certain strategic policies.

Technical Assistance for Gmina Best Practice Dissemination and Pilot Projects: The "Mega Demonstration Project"

Innovative and successful approaches to many of the important housing issues addressed by HUDA—TBS housing development, rehab strategies, privatization strategies, housing association improvements, and so forth—have been initiated by gminas. USAID continues to be active in these types of projects and we recommend further dissemination of gmina best practice and additional pilot projects. In addition, however, the team is concerned with the overall integration of a consistent set of housing policies. We therefore also recommend a "mega voivod/gmina pilot project", combining a number of housing policy reforms. Two potential recommendations are noted below:

■ **Powiat or Voivod Housing Rent and Housing Allowance Demonstration Project.** Housing allowances are administered, in part, at the Voivod level. A pilot project should be undertaken to combine rent reform with a restructured housing allowance program. The housing allowance portion could be done at the voivod (or powiat) level. Rent reform is likely to be a gmina-based program (although some attempt could be made to have all gminas within a powiat, for example, address rent policy).

■ **Gmina Rehabilitation Pilot within the Powiat Demonstration Project.** The powiat/voivod housing allowance demonstration should then be combined with other gmina-based projects. For example, in the team's view, rehabilitation is associated with, or driven by, nearly all the elements of the policy framework: increased rents; the likelihood of increased privatization as a result of increased rents; the depth of the privatization discount in rehabilitated and non-rehabilitated buildings; the rationalization of the ownership structure in privatized buildings in order to better garner private resources to share in rehabilitation costs, and so forth. This recommendation for technical assistance could be viewed as a "mega pilot" which would test the consistency of an integrated policy set: rent, housing allowances, funding strategies for rehab, and the management skills of "best practice" TBS and/or building associations.

Government Funds for Housing, Rehabilitation, and Infrastructure: Accessing Private Capital

In addition, the team recommends that the government, HUDA, and BGK, for example, should rationalize the roles for BGK and develop a consistent set of goals and funding strategies, including access to private capital, for the National Housing Fund, the Renovation Credit Fund, and other proposals now being developed for infrastructure finance, loan guaranties, and so forth. Will the NHF, for example, finance rehabilitation? If so, on what terms? Are these terms consistent with proposals regarding the Renovation Fund? How many "funds" will actually be established within BGK?

Two important topics in this context are the strategy of providing subsidies for rehabilitation instead of infrastructure and the trade-offs between the two. It is possible, for example, that infrastructure can be largely financed with gmina resources, commercial borrowing, and municipal bonds, as utility prices have been greatly liberalized and the revenue flows can be collateralized. In contrast, rehabilitation is less likely to be funded by the private sector; rather, a case can be made that the problem is, in part, a national legacy and should receive preferential funding from the state. Basically, even with rent reform, rents could be expected to cover current operating and capital costs, not a huge backlog of capital repair requirements. On the premise that the state should intervene only where market will not, it is tentatively suggested that scarce state funds be devoted to rehabilitation, and that much of the funding for infrastructure be conducted at market rates. For gminas too small (or inexperienced) to fund their infrastructure through the market, BGK could raise market-rate funds through bond issuance and on-lend to these gminas.

In summary, subsidy policy should not compete with (and thereby stifle) development of private sector, market-based financing. Similarly, if the private sector is to be encouraged to assess and monitor the financial viability of projects on its own, state guarantees may not be needed in many circumstances. USAID is already providing technical assistance for gmina financial policies and planning; assistance to central strategies that support gminas could be integrated with these ongoing efforts.

TABLE 1: OVERVIEW OF MAJOR RECOMMENDATIONS

POLICY	*HUDA RECOMMENDATION*	*UIC TEAM COMMENTS*
NATIONAL HOUSING STRATEGIES AND SUPPORT SYSTEMS		
RENT REFORM	**INCREASE RENTS**	The UIC team suggests that rent reform is the most crucial policy change outstanding. Only concerted action by all gminas will result in a rental "market" supported by private resources. This may require incentives from HUDA and/or a "carrot-and-stick" approach to achieve adequate results; gmina education and "stakeholder" participation can assist.
HOUSING ALLOWANCE REFORM	**REFORMS IN ELIGIBILITY AND ASSOCIATED RULES**	Housing allowance reform is both crucial to supporting rent reform and should ultimately be the key subsidy policy. The housing allowance formula should be further revised: (1) in the short-run, linked to 3 percent of replacement cost; (2) in the long-run, linked to the "fair market cost" of adequate housing; (3) also in the long run, household contribution should be increased.
OVERALL HOUSING POLICY PILOT DEMONSTRATION	**(TO BE DISCUSSED WITH HUDA)**	The UIC team wishes to emphasize the important inter-relationships among policy elements and the need for consistency among them. A key example would be a demonstration project linking increased rents, housing allowance reform, and rehabilitation thereby supplementing increased rent revenues with NHF credits.
BUDGETARY LEGACY OF PAST PROGRAMS	**(TO BE DISCUSSED WITH HUDA)**	Support investigating methods to change the time horizons of those obligations, such as zero-coupon bonds, in order to relieve pressure on the budget.
GROWTH OF THE HOUSING STOCK		
FISCAL INCENTIVES FOR NEW CONSTRUCTION	**RETURN TO 1996 APPROACH TO TAX BENEFITS (LARGER BENEFITS)**	Suggest that current 1997 tax incentive approach is adequate to increase supply. Preferably, better-targeted policies should be encouraged, such as first-time homeowner grants and mortgage default insurance. The 1996 policy is highly regressive, very costly in terms of taxes foregone, and will be difficult to eliminate at a later date.
NHF AND THE TBS SYSTEM OF NEW RENTAL CONSTRUCTION	**HUDA HAS PROPOSED NUMEROUS "MICRO" IMPROVEMENTS TO THE SYSTEM**	Support HUDA's "micro" suggestions and propose adding long-term "macro" strategy: lessons learned from low-cost rental housing in US & Europe. Key problems there have included poor management, lack of incentives for private participation, inadequate funds for capital repair, and lack of tenant default policies.
VAT TAX	**MAINTAIN OR DECREASE CURRENT VAT RATES**	Limit VAT housing exemption to a simple lump sum per dwelling. Funds could be better utilized elsewhere.

TABLE 1 (CONTINUED)

POLICY	*HUDA RECOMMENDATION*	*UIC TEAM COMMENTS*
MAXIMUM USE OF EXISTING STOCK		
REHABILITATION	**NUMEROUS HUDA PROPOSALS: RENOVATION CREDIT SYSTEM THE MOST IMPORTANT; TAX RELIEF; AND LEGAL AND ORGANIZATIONAL ISSUES**	Rehabilitation demands more immediate attention and increased funding. The backlog in capital repairs is a "national legacy" which deserves state assistance. Two-pronged approach to TA: (1) gmina-based pilots (2) finalization of national strategies and credit systems
SOCIAL HOUSING	**NEW CONSTRUCTION AND BUILDING CODE CHANGES**	New construction not recommended. Make maximum use of existing stock and housing allowances. Understanding, measuring, and addressing homelessness have proved very difficult; "housing" and "social" policies should be integrated once causes are assessed.
INCREASING PRIVATE RESOURCES FOR HOUSING		
CONTRACT SAVINGS SYSTEMS	**IMPROVE AND MAKE COMPLEMENTARY**	It is suggested that HUDA support MOF's proposed amendments to Bausparkassen. Merger of the two systems should be considered. The Mortgage Bank Simulation Model (provided by USAID) can be used as an analysis tool.
MORTGAGE FUND	**CONTINUE TO DEVELOP CONCEPT OF MORTGAGE FUND; PRIVATIZE BUDBANK**	Privatize Budbank; maintain but transfer the Mortgage Fund. Consider sale and privatization. Universal banks may need liquidity in the future to support increased operations.
ENABLING STRATEGIES		
STATUTORY LIEN	**INVESTIGATE AND REDUCE DEGREE OF THE PROBLEM**	UIC has prepared a report addressing solutions to this problem in other CEE countries, the U.S. and Western Europe. It is proposed that mortgages be granted improved status and that a "level playing field" exist between universal and mortgage banks.
CONDOMINIUM MANAGEMENT STRATEGIES	**PROMOTE RATIONALIZED OWNERSHIP STRUCTURE**	UIC strongly agrees. Best practice/lessons learned from CEE and other countries should be analyzed.
TITLE REGISTRATION	**MAJOR IMPROVEMENTS REQUIRED**	UIC strongly supports. Integration of multiple ongoing efforts might be sought.

2. A FRAMEWORK FOR HOUSING SECTOR DEVELOPMENT

Market Allocation of Resources

Any attempt to prioritize the elements of the HUDA Strategy must flow from the principle that private (non-government) resources must account for the vast majority of spending on housing. In all market economies, most of the resources for housing come from mobilization of private resources, particularly the savings of households and firms.

The policy statement suggests that the role of the state focus on those areas where free market mechanisms fail to operate. It must be emphasized, however, that in Poland, as in other transition and many other countries, the state itself may be the reason that the market fails to operate. In order to develop a market-based housing and housing finance system, Poland must first address those aspects of the market that it has under its control—namely rents and the legal/regulatory framework.

The Need for Market Rents

A fundamental aspect of the free market is the role of prices as a signal to consumers and producers. Market determined prices are essential in the mobilization and effective allocation of resources. Housing prices (rents) for the large share of housing in are largely controlled by the gminas. Without market determined prices:

- The deterioration of the quality of the existing stock continues and accelerates because there are insufficient resources available for maintenance and improvement. As discussed below, there is demonstrable evidence of significant quality problems in the existing housing stock. Gminas do not have sufficient funds for major rehabilitation and thermal upgrading and look to the central budget for resources. Private owners do not have an incentive to even maintain, much less upgrade their units, unless they can be converted to commercial use. With higher rents, gminas and other owners will have more revenues available to invest in maintenance.

- Household and labor mobility is reduced. Households are reluctant to move and give up their below-market-rent apartments. This reduces labor mobility at a critical time in the economic transformation of Poland. It also leads to misallocation of space, as small families inhabit large apartments and large families inhabit small apartments. It also contributes to a black market in rentals where higher income households construct owner-occupied dwellings and sub-lease (at market rates) rent controlled apartments (at the expense of owners, whether private or gmina).

- Construction is not viewed as a profitable investment, because controlled rents are well below market clearing levels. Three percent of replacement cost is probably also well below a market level: at best, it may cover operating and maintenance expenses, but it will not provide an adequate rate of return to investors nor full recovery of the cost of the investment *in* new rental housing).

- It is impossible to determine the extent, if any, of a housing shortage in Poland. The Strategy Report states that "housing needs are estimated according to different sources at 1.5 - 2 million new units." Without market determined rents, there is no signal regarding excess demand or supply. If a shortage truly existed, the private sector would produce new units as long as the returns on such investment equaled or exceeded the risk-adjusted returns on alternative investments.

We applaud HUDA's recognition of the importance of this issue and their focus on increasing use of housing allowances and facilitating long-term budget planning by Gminas. However, we believe that it is essential that this message be made the top priority of HUDA and that HUDA press for stronger, integrated rent and housing allowance reforms. It is more crucial at this time than various new construction programs. In addition, as discussed below, we believe that HUDA must take a more decisive stance, either through education or more likely through a "carrot and stick" approach combining mandatory nationwide increases in minimum rents with, for example, increased funding for housing allowances and various rehabilitation and up-grading programs.

Improving the Legal and Regulatory Framework

A market-based system relies on the private ownership of property. This means that owners of property have the right to rent or own, transfer, lien or assign beneficial interest in property. Property ownership has both a legal and economic definition. If legal owners (landlords) do not have the right to set rents or evict tenants for non-payment of rents, they do not have economic ownership, at least while the tenant enjoys such privileges.

An important component of a private market for housing is an effective title registry system wherein property ownership is clearly identified and can be transferred and liens can be registered and enforced. The

HUDA strategy clearly identifies the inefficiencies and weaknesses of the current registration and lien system, noting that only 30 percent of all land is titled. They recommend full computerization of their system and increased in the title registration process and removal of the statutory lien which reduces the attractiveness of housing as collateral for lending. However, as HUDA notes, the Ministries of Finance and Justice are primarily responsible for these areas. HUDA could take an active role in coordinating the government's policies regarding title registration and lien enforcement.

Macroeconomic Stability and Public Expenditures

High interest rates are an extremely significant barrier to the housing sector. A reduction in interest rates will have a much larger impact on housing affordability than any state program. Significant progress has been made in controlling inflation. However, real interest rates have risen sharply due to a reduction in investor confidence in developing and transition economies. High real interest rates may very well be temporary and new programs aimed at improving affordability should not be predicated on their continuation.

Budgetary discipline is a key component to controlling interest rates. We believe that focusing on a large increase in the percentage of the budget (and GDP) spent on housing is not appropriate in the current macroeconomic environment. We recognize that a major portion of budgetary expenditure must be devoted to paying off the legacy of old policies; a proposal to ameliorate this situation is presented in Section 3. Currently, there is major pressure on the state budget to fund reforms in education, health care and social security as well as rationalizing the mining and heavy industry sectors, but the deficit must be kept under control if Poland hopes to join the European Union in the 2002-4 time period. Large increases in the state budget can be inflationary and can undermine investor confidence in the economic policies of the government.

The level of support the state provides for housing has, in fact, been significantly higher than the 0.6 percent quoted in the strategy because of generous tax incentive policies. If HUDA reinstates, as it proposes, the version of the tax benefit in effect in 1996, there would be significant revenues foregone in the future. It should be recognized that all such incentives are counter to the avowed policy of the government to seek to reduce the drag on economic growth caused by the deficit and the current tax system, because these incentives increase the deficit and feed the public’s desire to reduce their tax burden by offering greater deductions and credits rather than instituting lower tax rates.

Mobilizing Private Resources for Housing

Facilitating the expansion of private resources for housing investment is an important priority for the state. In market economies this is accomplished through the development of an effective housing finance system and savings targeted towards housing.

Although commercial banks have been entering the mortgage market over the past few years, for the most part their lending has been conservative, small scale and targeted towards higher income customers. A major reason for this cautious approach is the high perceived risk of mortgage lending. Removal of the statutory lien and improvement in the title registration system will significantly reduce the risk of housing lending for banks and lead to greater involvement. Development of a mortgage bond system will increase the supply of funds from institutional investors (in particular the newly created private pension system) and reduce the liquidity risks of housing lending.

Until the economy stabilizes and interest rates fall, affordability of mortgage lending will be an issue in Poland. The dual indexed mortgage and other deferred payment mortgages are methods of improving affordability without subsidy that have enjoyed some success in Poland. There continues to be a need for this instrument in Poland and HUDA should support its continued use (e.g., through continuation of the Mortgage Fund as discussed below).

Contract savings for housing programs may lead to an expansion of funds available for housing. However, they will not lead to meaningful investment in the housing sector for another 3-4 years. Furthermore, experience has shown in other countries that these schemes are at best a supplementary form of finance for housing. As discussed below, they may be well suited to mobilize resources for rehabilitation and improvement.

We recognize, however, that it will take time for the private sector to significantly increase the volume of mortgage lending. Until rents can produce sufficient cash flow to support mortgage loans or interest rates fall to a level at which they are affordable to the average household, the sector will not receive sufficient funds to support needed rehabilitation and improvement. HUDA has addressed these needs in the Strategy, the specifics of which are discussed below. In its framework HUDA should focus attention on mechanisms that facilitate the mobilization of private sector funds as opposed to direct budgetary resources. This can be accomplished through partial loan guarantee programs and direct subsidy programs linked with obtaining a market-rate loan.

Principles of Program Design

The team recognizes the need for government budgetary support for the housing sector. Our review suggests that priority be given to housing allowances and other mechanisms that facilitate the raising of rents to market levels, improving the legal and regulatory framework governing the sector and supporting the mobilization of private sector funds (for savings and lending). Because the proper incentives for consumers and producers are not currently in the system, and because the proposed tax incentive is highly regressive, the team believes that it is inappropriate to heavily subsidize new construction. New construction subsidy programs may be justifiable in certain metropolitan areas with substantial excess demand and supply constraints which are particularly difficult to remove.

Given a role for government in these areas, what types of programs should HUDA pursue? An important characteristic of any subsidy program is *efficiency*. There are two aspects of efficiency: administrative and economic. Administrative efficiency refers to the costs of program administration as well as the transparency of such programs. Programs should be designed to minimize the administrative cost and burden (particularly at the gmina level). Thus, HUDA should address administration and administrative costs in its program proposals. Economic efficiency means accomplishing the desired change with the least social cost. This means focusing program resources on those economic agents who will change their behavior (e.g., inducing more people to construct or rehabilitate their homes) as opposed to those who would engage in the activity without the government's support.

A second important characteristic is appropriate *targeting*. HUDA addresses the importance of targeting at the end of the document by recognizing that households with different income levels have different housing needs. However, there is no prioritization given to these needs. Are the needs (and thus resource demands) of lower income households more important than the needs of higher income households? How should regressivity and progressivity be viewed in assessing HUDA policies? And finally, another important aspect of targeting—not subsidizing those who can afford to pay—would be greatly helped by raising rents.

3. OVERVIEW OF GOVERNMENT EXPENDITURES ON PUBLIC HOUSING FINANCE AND THE LEGACY OF PAST POLICIES

Current State Support for Housing

The true "state-generated" level of support to housing is not known. It is clear that the total value of the subsidies to the sector are far higher than the figures that appear in the "housing sector budget" as developed by HUDA and the Ministry of Finance. Other expenditures and resources include: (1) the degree to which local governments and private landlords charge rents lower than those that would appear in a free market in rental housing; (2) housing allowances and many other gmina-level subsidies;

and (3) the tax subsidies (that is, credits or deductions that represent revenues foregone) at the central level.

The responsibilities for the housing sector which have been shifted to the level of the gminas include not only the ownership of most of the remaining government-owned rental housing, but also a portion of the funding of housing allowances, the decision about the terms under which the units might be privatized, the responsibility for maintaining and renovating the stock, and the potential for supporting (through TBS or directly) the creation of additional regulated rental units. There are, however, no comprehensive data on the budget and off-budget support that the gminas provide. Thus, a budget analysis is only partial. It is possible that the total of all expenditures taken together are on the order of the 3.5 to 4.5 percent of GDP that has been declared as a desirable level of government support of the sector.

Current Status

If we restrict our focus to only central government expenditures and only to those that are not associated with past commitments, there is still a fair degree of support for the housing sector. The largest explicit outlay is for the central government portion of housing allowance payments. This is budgeted at PLN 497 million in 1998, up from PLN 429 in 1997. HUDA estimates that for 1997, actual state outlays were PLN 323.3 million with an equivalent amount being provided by the gminas, for a total of PLN 646.6 million; this total provided allowances for 646,800 households. In 1998, state expenditures are estimated to be PLN 477.3 million, about 0.1 percent of forecast GDP; with gmina contribution, the total increases to 0.2 percent of expected GDP. This is equivalent to roughly perhaps 15 percent of the average income of participants in 1998[1]. It is notable that the inflation-adjusted amount spent on this subsidy has been increasing steadily since the start of the program in 1994. It appears that this reflects both increases in rents and other housing expenses and also an increase in the share of eligible households that actually participate.

[1] We do not have direct information on the average income of the participants. However, the maximum income for eligibility is 150 percent of the minimum pension for single-person households and 100 percent of the minimum pension per person in larger households. The average monthly allowance in 1998 is expected to be PLN 97 per month. Since the minimum pension is PLN 4728 per year in 1998, and assuming that the average size of a participating household is 2.5 persons, the ratio of average benefit (1164 per year) to maximum income is about 9.8 percent. Since the average income must be less than the maximum, the ratio on average is probably 15 percent or a higher, a very substantial boost to income.

The second largest state expenditure on the housing sector is its annual contribution to the National Housing Fund. In 1998, that amount is budgeted at PLN 270 million, up about 23 percent from 1997. This amount is not entirely a loss to the central government, however, since most of it will go to loans which have a significant present value upon repayment, but the NHF is lagging in actually making these loans. Thus, much of the cash will stay in the BGK for the moment. This cash is nevertheless accounted for as a full expenditure. The major program funded through the NHF is the TBS system, which itself can be used to finance a variety of housing-related investment projects. The TBS system also requires gminas to commit to providing subsidies, but the amount of that subsidy cannot be determined.

It must be emphasized that Poland has chosen to convey major subsidies through tax-related benefits. There are a number of such subsidies, and in the aggregate the Ministry of Finance estimated the programs to have cost the government revenues of about PLN 2.6 billion in 1996, or about 0.75 percent of GDP in 1996. As a point of comparison, the total of all subsidies in 1998 allocated for housing allowances (PLN 497 million), the National Housing Fund (PLN 270 million) and the new thermal renovation fund (PLN 30 million) is about PLN 800 million. The tax revenues foregone in 1996 were well over three times this amount. In addition, this substantial tax figure does not include any estimate of revenues foregone from the favorable rate of VAT applied to housing.

The Legacy of State Resources Devoted to Previous Housing Policies

As has been stressed, the legacy of the old programs is a major burden to the state budget and a major obstacle to the implementation of new housing programs. Two previous programs take a large portion of the current state housing budget. These programs are obligations of the government, the first to provide loans to participants in a contract savings program run by PKO-BP. Originally the funds had to be used for new construction but in 1994 the program was expanded to include loans to buy existing units. The other major program was the provision of indexed mortgage loans for members of co-operatives. PKO-BP holds nearly PLN 4 billion of these loans and the government pays the deferred interest to the bank.

Current Status

In the 1998 housing budget (PLN 3005.8 million), buy-outs of loan interest (PLN 1105 million or 37 percent of the budget) and reimbursement of guaranteed premium payment for owners of contract savings-bank books

(PLN 826 million or 27 percent of the budget) constitute a majority share of State budget housing expenses.

Taking into consideration maintaining trust in the State—and the fact that premiums paid are probably used in part to finance purchase or construction of new units—it does not appear feasible to alter the “rules” of calculating the premiums and thereby decrease State expenses for that purpose in real terms. However, some recipients may not be interested in acquiring a dwelling and receiving the premium; they should be given an opportunity to exchange the premium for another type of benefit, such as exchanging savings bank books for long-term Treasury bonds or some other benefit.

At the same time, the current situation in the housing industry indicates an urgent need for government action directed at other policies, in order, for example, to increase maintenance of the housing stock. It will be necessary to undertake measures shortening the interest buy-out period to gradually reduce expenses. This might be achieved in a number of different ways, such as:

- Providing greater incentives for repayment of the loan all at once;
- By securing debts of some cooperative members who possess cooperative ownership rights by a mortgage, preceded by the transformation of cooperative ownership rights to a regular ownership right and securing an agreement to new terms of a loan contract between the bank and homeowners; or
- By introducing limitations on interest buy-out and replacing \ modifying this form of State liability.

Issues and Options

The subsidy on the cooperative loan portfolio consists of payments to PKO-BP of the difference between the payments made by borrowers and the payments required under the loan terms. Borrower payments are based on a complex formula related to both the size of a unit and average income. The accrual rate on the loan is the 26-week Treasury Bill rate. The difference is deferred interest that is paid quarterly to PKO-BP and capitalized as an asset on the government’s balance sheet.[2]

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[2] Borrower payments are allocated first to principal, then to current interest and then capitalized interest. If borrower payments are insufficient to cover principal and current interest, the government makes up the difference to PKO-BP. The debt has a 20 year term and any

The residential portfolio (over 90 percent) is performing well. For example, PKO-BP reports a delinquency rate of approximately 3 percent of the residential portion of the old cooperative loan portfolio. But the much smaller commercial portfolio has a default rate in excess of 60 percent. The NBP would like to develop an alternative structure for the portfolio in order to enhance the prospects of privatization of the bank. The bank has been satisfied with the performance of the residential portfolio, particularly since the government advances capitalized interest. However, they are concerned that the NBP will require substantial reserves to be held against the deferred interest. Because the deferred interest is an asset of the government, it is unclear whether the NBP is applying a general policy of reserving against deferred interest on all mortgages for all banks (including Mortgage Fund participants) or just for PKO-BP.

From a policy standpoint the issue is one of timing. Borrowers can defer part of their mortgage payment which is capitalized into the loan balance to be paid at a later date. The government pays any difference between a fully amortizing payment and the actual borrower payment to the bank.[3]

The rationale for converting the deferred interest payments into current cash is that PKO-BP is funding the loans with non-indexed deposits that require the payment of current interest. Although deferred interest mortgages subject the bank to liquidity risk, the fact is that the bank is the most liquid financial institution in Poland. By virtue of its historical position as the only retail depository institution in Poland and extensive branch network, it has a very large and stable deposit base. As of December 31, 1997, 46 percent of its assets were in the form of government bonds. Most of its loans are short-term interbank loans. Although more analysis of its financial position is needed, it is quite likely that it could finance the future deferred interest with no material erosion in its cash flow position.

If this is true, the government could stop paying deferred interest to PKO-BP. In that event, the bank would record the capitalized interest as an asset on its balance sheet. This change would reduce the current budgetary obligation for the co-operative portfolio. The government would

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outstanding balance remaining at that time will be canceled.

[3] The loans are currently producing a 1.2 percent monthly payment amount. Although still less than a fully amortizing payment, this level of payment suggest that the loans will amortize in another 8-12 years. Note there are differences across vintages. However, conventional wisdom is that the much of the current deferred interest owed to the government will never be repaid, as it will be forgiven at the end of the loan term). A more detailed analysis of the loan is needed to establish its projected payment and remaining term.

have a contingent liability if the loans did not pay off—a liability it holds anyway.[4] The complicating factor is the prospect of privatization. If the government plans to privatize PKO-BP within the next 5-7 years, investors may discount the value of the portfolio due to a lack of understanding of the loans and/or concerns about future cash flow.

An alternative approach is to swap the cooperative loan portfolio for an equivalent amount of zero-coupon, indexed government bonds. The maturities of the bonds would be staggered (e.g., from 1 to 15 years) to reflect the forecast cash flow from the loans. Although the bonds would pay no current coupon, their value would adjust periodically to reflect past inflation. The bonds would be issued at a discount in order for their yield to equal that of comparable market investments. *Note: This would have to be inferred for cash flows beyond current long-term government bond yields.*

The loans could become assets of the government (for example, in BGK) and the bonds would be assets of PKO-BP. The government's current cash needs would be reduced by not having to pay the current interest on the loans to PKO-BP. The bank would receive government guaranteed assets that will facilitate its eventual privatization. PKO-BP is very liquid and can afford to have zero-coupon bonds on its balance sheet.

Technical Assistance

The financial condition of PKO-BP may allow the government to stop paying deferred interest on cooperative mortgages to the bank. This would reduce the current burden on the state budget and perhaps free up resources for other programs. Alternatively, the government could swap zero-coupon indexed bonds for the cooperative loan portfolio.

The feasibility of these approaches cannot be established without more information on the characteristics and performance of the loan portfolio and PKO's financial condition. A technical assistance project would involve a detailed analysis of the loan instrument, using a modified version of a simulation model already in use in Poland by the UIC team. In addition, the analysis would include a forecast of the cash flows of the residential portfolio under different macroeconomic assumptions and development of a financing strategy for PKO-BP under the two scenarios of discontinuing payment of deferred interest and the bond swap.

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4 Note that we are referring to future deferred interest, not the capitalized past interest on the government's balance sheet.

4. RENT REFORM AND AN IMPROVED HOUSING ALLOWANCE PROGRAM

Overview

As has been stressed throughout this report, the UIC team considers rent reform to be the most crucial aspect of housing reform in Poland at the present time. The framework for housing sector development presented in Section 2 describes the importance of a market-determined rent structure in furthering private sector participation in increasing housing supply, both rental and homeowner. Maintaining subsidized rents not only dampens incentives to increase supply, but also provides an unnecessary "income transfer" to households living in rent-controlled stock but who do not require assistance to make their housing affordable.

We therefore applaud HUDA's support of rent increases, their proposals to strengthen the housing allowance program, and their recommendation that gminas increasingly rely on long-term planning and budgeting to help set a rent reform plan in place. Our recommendations—which are designed to further strengthen HUDA's rent and housing allowance proposals and, thereafter, to consider testing these proposals in a gmina/voivod pilot program—should be seen in this overall context. Our recommendations include the following:

- To find some mechanism whereby gminas which, for a variety of political and social reasons, are reluctant to push for rent reform are "propelled" into it via incentives and a better understanding of rent policy (or even "pushed" into it via legislative mandate).

- To aim to ultimately increase rents beyond the 3 percent of replacement cost target, as this rent level, is probably not a "market" level, especially in the long-run, as it cannot generally support proper capital repair of the housing stock.

- To reform the housing allowance program to be consistent with the increase in rents—that is, so that the units are affordable with rents at 3 percent—and to further simplify the eligibility rules.

- To institute revised rent structures which "mimic" free market rent structures as much as possible: that is, the variation in rents to reflect differences in unit and building quality and locational and neighborhood amenities.[5]

The Rent and "Best Practice" Study

The information on rents and housing allowances discussed in this report has been drawn from a USAID-sponsored study currently being completed by the UIC team. The study, *Gmina Rent Policy Management in Communal Housing: Rent Strategies and "Best Practice" Housing Management* (hereafter referred to as the "Rent Study"), examines rent policy, housing allowance utilization, and a variety of related topics, including the "best practice" processes through which a few gminas have managed to overcome considerable resistance to rent reform.

The Rent Study relies on data from the Housing Research Institute (HRI), which collects information on an ongoing basis from 120 gminas. The HRI sample is a representative sample of Polish gminas, differentiated by geographic location and gminas size. Thus, the summary statistics are assumed to represent "all Poland" reasonably well.[6] In order to make maximum use of housing data collected by the Housing Research Institute, as well as to better understand gmina decision making processes with regard to rent reform, three separate tasks were undertaken to analyze current rent policy and to discover "best practice" strategies:

- Analysis of existing data in order to assess the current situation with regard to rent level, rent structure, rent burden, privatization, and housing allowance participation.

- Interviews with a sample of fifteen gminas to ascertain their overall policies and goals for rent management and the role of rent policy in their housing strategies.

- A more detailed study of a small sample of gminas which have developed "best practices" in rent policy. From the initial sample

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[5] Rent structure was discussed at a USAID-sponsored workshop in Poznan in 1995. It may be time to revisit this issue, since the gminas have now had some experience in adjusting rents according to quality and location. A "How-to Manual" on rent restructuring was translated and distributed following the conference; this Manual could be more broadly distributed, perhaps through a follow-up conference on rent "best practices" (see technical assistance suggestions).

[6] The HRI data were specially tabulated and presented for the Rent Study by Wanda Urbanska. HRI staff Jan Kornilowicz, Hanna Kulesza, and Wanda Urbanska - Coordinator, prepared two special reports for the Rent Study: *Residential Rents, Funding of Municipal Housing Maintenance, and Housing Allowances,* and *Rent Levels and Rent Reform Analysis in Polish Gminas*.

of fifteen, five gminas were selected which represent a best practice in one or more aspects of rent setting and/or housing management. Follow-up interviews were conducted with this sub-sample to focus on the best practice aspects of their housing policy.

The fifteen gminas in the interview sample provide a wide distribution of city size, geographic location, and the current status of economic well being. The gminas include Lublin, òyrardów, Đrem, Tarnów, P»ock, Dzieróoniów, Sopot, L“bork, ºódï, Pozna½, Gdynia, Ostrów Wielkopolski, Radom, Kraków, and Szczecin. (Of these, the last five make up the “best practice” sample.)

Findings

- **Rent Level.** Rents in communal and other rent-controlled housing in Poland are still well below what could be considered either economic or market levels. Furthermore, the pace of increase has generally slowed since the initial boost—from extremely low levels—between 1994 and 1996. Currently, the majority of gminas do not appear to be in the process of bringing rents anywhere near the “ceiling” level of 3 percent of replacement cost. Across Poland, average rent for a “typical” unit in March 1998 was somewhat less than PLN 1.5 per square meter. For the 15 gminas analyzed in more detail in the Rent Study, rent for a typical unit ranged from PLN 0.55 to 1.98 per square meter in March 1998. As of March 1998, this represents from 0.5 to 1.7 percent of replacement cost for a typical unit for these gminas; for Poland overall, the average is estimated to be about 1.0 percent of replacement cost.

- **Housing Allowance Utilization.** As of September 1997, only 6.2 percent of households and only 10.5 percent of tenants in communal housing received housing allowances in Poland. Many fewer households participate in the housing allowance program than was originally expected. According to the discussions with gminas, some households do not apply for housing allowances because of pride and/or a wish to disguise their actual income. Although most gminas in the interview sample have active programs to seek out those who qualify for allowances, some gminas noted that outreach could be improved.

- **The Opposition to Rent Increases.** This is a complex issue, involving (1) social and political opposition; (2) misunderstanding on the part of gminas who fear that rent increases will leave them worse off, on balance, because of the resulting increase in housing allowance payments; (3) a genuine—and correct—concern that some of the households not eligible for a housing allowance will face severe affordability problems; and (4) the perception that “rents” are already very high because of increases in utility prices. Although there is very little data with which to assess the rent burden situation accurately, it appears that substantial increases in utility payments have, in fact, increased gross rent burdens, perhaps significantly so for some households.

Due in part to local elections in 1998, some gmina councils have recently either rejected rent increases or decreased previously planned-for shifts in rents towards the target of 3 percent of replacement costs. There is still strong political resistance to raising communal rents. In addition, as discussed below, it is indeed the case that without housing allowance reform, lower income tenants who are not currently eligible for an allowance will suffer if rents are raised.

■ **Best Practice Findings.** Three of the five “best practice” gminas were selected because of successes in rent policy. Gdynia and Szczecin were selected because they have raised rents to a much greater extent than most other gminas; Krakow, although it has not yet undertaken significant rent increases, has initiated a sophisticated process of creating a “market-based” rent structure.

Gdynia and Szczecin. Both of these gminas have “aggressive” rent policies; they are among the few gminas which have planned for regular rent increases and both plan to achieve the 3 percent goal on or before 2004. For typical units, as of March 1998, rents were 1.7 percent and 1.4 percent of replacement cost in Gdynia and Szczecin respectively; rents for “full standard” units were at 2.2 percent and 1.9 percent of replacement cost. Szczecin and Gdynia have shown that it is possible to overcome the political and social opposition to rent increases by carefully involving all housing market “stakeholders” (council members, tenants, citizens, and gmina officials) in discussing proposals for increasing rents to market levels. And, as noted, these gminas have also made rent increases part of comprehensive and long-term plans for the housing sector.

Krakow. Gminas are acting with widely different schemes and approaches to varying the structure of rents as well as the rent level. Most have addressed this requirement in some fashion, and some have developed detailed “point” schemes. Only Krakow, to our knowledge, has initiated the process of establishing variations in rents through application of a market-based methodology (the “hedonic” technique). This technique was introduced in the Poznan Rent Conference in May 1995 (cited in a footnote above). It could ultimately be very helpful to most large gminas as they adopt market-based rent structures in the gmina-owned portion of the stock and/or for the stock which the gmina continues to set rent. Krakow’s experience in gaining the approval of this approach by the gmina council is interesting in itself.

Recommendations

Rent Reform

HUDA’s Strategy Report clearly states that rent reform is very important. It is not clear, however, whether rent reform “encouragement” by HUDA and/or education campaigns will suffice to overcome resistance to rent increases. The central government will have to develop a more effective approach to ensuring that rent reform takes place as soon as possible. This would need to be done either through legislation or by providing some "carrot and stick" incentive policies to ensure that reluctant gminas actually undertake the necessary increases. As discussed below, further housing allowance reform will be critical to supporting affordability if rents are increased.

As noted, although gminas have complied with the general requirements of rent restructuring, most have adopted "point count" structures, whereby percentage discounts and/or premiums change rents to account for negative and positive unit features. Although some gminas have included quite numerous features in these schemes, they could be improved by utilizing some market-based methodologies used to price housing in Western Europe and the United States.

Finally, we recommend that HUDA considers altering its long run rent target to a figure above 3 percent of replacement cost. As discussed above, it is unlikely that this figure will be sufficient to cover capital repairs; thus, improved long-term maintenance, one of the main reasons for introducing rent reform, will not be properly supported.

Housing Allowance Reform

HUDA has also recommended reform of the housing allowance program. In summary, HUDA has proposed that income eligibility be increased to a higher proportion of the minimum pension and the rules regarding space and other eligibility requirements be made more flexible. Also, the eligibility "cutoff points" have been made gradual (to avoid the cliff effect seen in many means-tested programs).

The UIC team is currently analyzing data on affordability in more detail, and will provide the results of a brief simulation in the Final Report.[7] Our very preliminary estimates indicate that without any reform of the housing allowance, rent burdens for households just above the income eligibility level would range from 58 percent of income to 67 percent of income for rent and utilities if rents were immediately increased to 3 percent of replacement costs. Using HUDA's new income eligibility limits, it appears that rent burdens would range between 39 and 45 percent of income for households not eligible for an allowance—again if rents were

[7] The Final Report will include an overall analysis of affordability for different segments of the income distribution and an assessment of which subsidy policies are directed at which segment of the income distribution. This analysis will also attempt to determine which groups, if any, seem to be left with an affordability problem but no subsidy policy in place to assist them.

boosted to 3 percent of replacement costs. Clearly, these payment burdens are excessive, so there would remain a genuine concern over increasing rents even with HUDA's proposed allowance reforms. A quantitative analysis should be designed and carried out in conjunction with HUDA, as we suggest below under the technical assistance proposals.

We suggest a number of alternative parameters for reform of the housing allowance. First and foremost, the formula used to improve the allowance program should be tied to the rent policy reform goals, rather than to more arbitrary income ceilings that pertain to pension policy. In this fashion, affordability would be ensured as rents move toward their replacement cost target.

This approach to the formula ensures that no matter what the level of rent (up to a defined ceiling), households would pay some fair portion of their income—perhaps 25 to 30 percent—and the allowance would cover the rest. This is the system that the U.S. has developed over many decades. In fact, technical assistance on this system was provided to countries such as Germany and Australia in reforming their allowance policies. Recently, technical assistance has been provided for other housing allowance systems in Central and Eastern Europe, as well as the NIS, which have adopted the "fair rent" approach.

Also, once the rent burden situation is clarified, we recommend gradually moving household contribution levels closer to the standards now in place in most Western countries. Housing assistance programs in the U.S., for example, require households to pay about 25 to 30 percent of income on housing. Differences in the level of real income have to be analyzed, however, so that very poor households are able to afford other necessities.

Technical Assistance

If it is assumed that gminas will not respond to informational campaigns (suggested below) and to the support provided by a greatly improved housing allowance, UIC proposed that HUDA develop incentives to push rent reform forward. We also suggest a pilot program for testing rent and housing allowance reforms.

Stronger GOP Incentives for Rent Reform? The GOP could implement an incentive program which, for example:

- Offers more generous revenue sharing in housing allowance programs if rents are increased; or

- Makes rehabilitation (or other preferential) assistance dependent on a specified plan for rent increases.

Or, the GOP could combine these “carrots” with some type of a “stick”:

- Revenue-sharing in the housing allowance program could be made less generous if plans with regard to rent increases are not implemented; and/or

- Borrowing from the National Housing Fund would occur on less favorable financial terms if suitable plans for rent reform were not adopted.

Powiat/Voivod Housing Rent and Housing Allowance Demonstration Project.

Housing allowances are administered, in part, at the voivod level. A pilot project could be undertaken to combine rent reform with a restructured housing allowance program. The housing allowance portion could be done at the voivod (or powiat) level. Rent reform is likely to be a gmina-based program, although some attempt could be made to have all gminas within a powiat address rent policy. The powiat/voivod housing allowance demonstration should then be combined with other gmina-based projects. As noted in the overview, this recommendation for technical assistance could be viewed as a “mega pilot” which would test the consistency of an integrated set of policies: rent, housing allowances and, for example, funding strategies for rehabilitation.

Gmina-Sponsored Best Practice Rent Workshop: Long-term Planning and Stakeholder Analysis

Interviews conducted during the conduct of the USAID-sponsored Rent Study noted above, suggest that gminas which have successfully implemented higher rent increases have adopted two important tools: (1) stakeholder involvement and (2) long-term planning for housing policy. Councilors and city hall departments played a very important role in preparing long-term reforms in housing policy and various stakeholders in rent policy were actively involved in setting rent levels. In general, the rent-setting processes were very transparent. It has also proved to be important that the gminas are very proactive in seeking out those who qualify for housing allowances, thus minimizing the number of potential opponents of the rent increases.

The best practice gminas that have already introduced “unpopular” policy changes are convinced that the way can be smoothed through two important means:

- Intense and ongoing involvement of the important stakeholders.

- Education of council member and other stakeholders as to the importance and benefits of rent reform. Topics in an ad education campaign might include:

  — The revenue impacts of increased rents, emphasizing that gminas will cease subsidizing those not in need.

  — Revenues required for adequate maintenance and rehabilitation.

  — Support offered by a restructured housing allowance program and the *net* revenue impact of rent and housing allowance increases.[8]

Improvement in the Housing Allowance Program

An effective housing allowance will be of critical importance in the ability of gminas to increase rent. As noted, HUDA has proposed revisions to the current program which increase the income eligibility limits, based on a percentage of the lowest pension, and make the space limit rules more flexible. The team suggests that the reforms go beyond those suggested in the Strategy Report in order to firmly link the housing allowance payment to the targeted rent levels in the reform program. In this fashion, affordability is assured up to a specified rent level. A quantitative simulation could be carried out in conjunction with HUDA. The essence of the team’s argument is the following:

- Structure the housing allowance so that eligibility is not linked to normative income levels (which are part of Poland’s income transfer programs), but rather linked to the cost of housing itself, which varies regionally and by urban and rural areas within the regions. Eligibility would be linked to a “fair” cost of housing—the rent required to live in modest, typical housing. Currently, 3

[8] See, for instance, “Srem Housing Stock Management Information System”, Sally Merrill and Tony Phipps, PADCO for USAID/Warsaw, November 1996. “program Dodatków Mieszkaniowych: Informator o Procedurach”, Ewa Bo½czak-Kucharczyk and others, PADCO for USAID/Warsaw, July 1995.

percent of replacement cost would seem to be the prevailing choice, but could be adjusted later. In the U.S., the rent parameter is known as "fair market rent", and is based on market surveys of housing costs and other factors;

- Space limitations should be greatly modified, or preferably dropped altogether. Assigning tenants to units suitable to their household characteristics should not be a function of the housing allowance, but rather of other housing policies dealing with unit exchange; and

- Finally, as recommended, the proportion of income dedicated to housing should be gradually increased above the present parameters in the formula, which are low by the standards now utilized in Western Europe and the U.S. Clearly, Poland's level of income and structure of expenditures must be considered, and the lowest income households should not pay a share for housing that deprives them of other necessities, but generally, the payment parameters for households may be too low.

Workshops on Best Practice Rent Structures

Following, or combined with, workshops on "best practice" reforms of rent levels (see above), HUDA should convene a gmina-based task force to compare the ways that gminas have established variations in the rent of communal stock, with a view to advising gminas on how to rationalize and simplify the procedures. The relevance of these reforms will become more apparent as rents move toward the target set for 2004 and gminas continue to try to better match households and housing units. Rent restructuring—that is, mimicking market rents with regard to variations for quality and location—has guided reforms in Western Europe's public housing stock in the last several decades, better allowing the "market" to match tenants to units.

5. GROWTH OF THE HOUSING STOCK

Fiscal Incentives for New Construction

The HUDA Strategy makes several recommendations with respect to fiscal incentives on both the demand and supply sides for new housing construction. First and foremost, Section III.3.1 seeks reinstatement of the rule allowing deduction of the permitted investments in housing instead of simply taking a credit set at the lowest tax rate. In 1996, the actual amount of the rebate was determined by the value of the tax deduction according to the tax rates applicable to that income. Since the maximum tax rate was 45 percent in 1996, a household with very high income could benefit from a rebate of up to 45 percent of PLN 64,400 (the limit on the eligible expenditure). In 1997, the amount of tax savings was capped at an amount roughly equal to the lowest tax bracket (19 percent) times PLN 64,400.

HUDA's proposal is to return to the higher benefit scheme. This is a very significant subsidy: the Ministry of Finance estimated that in 1996, the subsidy—or taxes foregone—equaled PLN 2.6 billion.

Recommendation

The team supports the use of fiscal incentives as a policy to increase the housing supply. However, we propose that the GOP simply retain the lower (1997) benefit structure. Our reasoning is as follows:

The use of fiscal incentives has at least two advantages over direct state or gmina investment in new housing. First, such subsidies do not have to go through bureaucratic or allocative channels to take effect, thus avoiding political considerations in their allocation as well as additional administrative costs, such as the overhead of the BGK under the NHF/TBS system. Secondly, the housing, whether owner-occupied or rental, would be built in the private sector, with clear incentives for appropriate allocation and maintenance.

■ **Advantages of HUDA's proposal.** A very large tax break, such as proposed by HUDA, may be predicated on three presumptions. First, large social benefits accrue to all of the stock from additions to the top end of the housing stock.[9] Second, incentives should be weighted towards those with ready cash, rather than just those with reasonable access to long-term

[9] There is some controversy over whether such additions have beneficial effects on housing in the lower quality portions of the stock. There is strong evidence in support of this proposition in free-market housing markets, but it is not certain in the Polish market.

finance. Third, the extra subsidy derived by fairly high income households because the subsidy is a deduction rather than an allowance actually causes a significantly larger number of these households to start houses than would otherwise be the case.

■ **Disadvantages of HUDA's proposal.** There are a number of caveats, however, which lead us to prefer the lower benefit scheme. These caveats are especially relevant for the longer term. First, the proposed tax policy is highly regressive. Second, it is difficult to believe that the number of additional houses built is worth the extra loss of revenue from making it a deduction. (The only households with a significant gain from this provision have the highest incomes in Poland and are probably in the market already for a better house than they had under the previous system.) Thus, we suggest that the state's funds (those "saved" by keeping the lower tax benefit scheme) are best spent elsewhere. In addition, it must be emphasized that such major tax advantages generally have a relatively hidden, long-term, insidious effect. As the deduction becomes more entrenched and commonly used, taxpayers view it as a major softener of the burden of high marginal tax rates. In effect, for many taxpayers facing rates as high as 40-45 percent, continuing to make large investments in housing will reduce their actual taxes paid as if the top rate was only 30-35 percent. Yet the actual high marginal rate will continue to weigh upon their work effort decisions and choices on making investments with fully-taxable returns.

These distortions can be very serious for the economic evolution of the society and are a good basis for argument for avoiding marginal tax rates that are so high. However, it becomes very difficult to orchestrate a reduction in tax savings for housing expenditures in return for lower tax rates, as illustrated by the difficulty in the U.S. of significantly scaling back the very regressive tax break for housing.[10]

Technical Assistance

The GOP may wish to continue this discussion of tax policies with USAID consultants. Reform of Poland's tax system is currently a major topic of discussion. The advantages and disadvantages of various tax

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[10] Moreover, certain abuses may be creeping in to the Polish system. The deduction is understood to apply to annual qualifying expenditures, even for the same residence. If so, there is a significant potential for construction to be spread out over several years, or for additions to be made to a house that already has benefited from the subsidy. Cumulative deductions should be limited to the total ceiling for a single residence and not be applicable for small additions or improvements.

subsidies is an issue which has received extensive attention in most developed countries and has engendered many efforts to reduce marginal tax rates and other distortions created by taxes and tax advantages. The discussion also includes the difficulty of ending a policy which may be intended to be a short-term stimulus rather than a permanent feature of housing policy. Policy makers who may wish in the future to eliminate the tax break entirely or reduce its generosity will find that once entrenched, such benefits are difficult (or impossible) to remove.

Preferential Treatments Under the VAT

It has been argued that because of a perceived urgent need for more housing construction, existing VAT advantages should be preserved. There are two weaknesses with this argument. First, it is not clear why just one of these tax advantages would not be sufficient to evoke sufficient supply response. Further analysis is needed as to what the marginal cost in foregone revenue is for an additional unit built. It is possible that adding the tax deduction to the VAT preferences is a very costly way of further boosting production. The second weakness is that a lower VAT rate for housing-related costs results in a reduction in cost of additional housing space and quality, not just a lower cost of building an additional unit. In other words, it encourages people to build larger and better units, not just more units. A preferable approach would be to provide a rebate on a portion of the full VAT on a limited amount of expenditure for a unit, thereby providing most people a lump-sum offset to the cost of building a house but not encouraging “over-building.”

Recommendation

As mentioned in Section III.3.3, the movement towards a single uniform tax VAT rate is being discussed; it will perhaps be lower than the current maximum rate. In that process, if favoring housing investments is still a priority, the subsidy amount should be limited through a specific amount of exemption per housing unit.

Technical Assistance

We suggest, as with the tax incentives for new construction, that discussions be held with the relevant institutions with regard to the costs and benefits of alternative tax incentives.

The National Housing Fund and the TBS System

The steady decline in construction of multi-family housing and the perceived inability of a majority of Polish families to purchase housing at full market prices led the Government of Poland to prioritize programs and policies to increase the development of rental housing. The existence of additional rental housing options could support greater labor mobility, facilitate economic restructuring and thus, ultimately, increase household incomes. Inspired by the Western European not-for-profit housing sectors that build, renovate and manage housing for a range of income groups, the Government passed legislation and ordinances to support the development of the TBS not-for-profit housing sector and mechanisms to finance rental housing. Preferential credit has been given to TBS and cooperatives for rental housing production and to gminas for housing-related infrastructure.

To date, the National Housing Fund (NHF) has granted loans totaling PLN 137 million to 60 projects producing 2,590 units. Of these loans, 15 are to cooperatives and the remainder to TBS. Ten loans are now being repaid and 661 apartments have been completed. Currently, 84 loan applications (30 from cooperatives) for new residential construction and modernization are under consideration for a total requested amount of PLN 315,080,374 to develop 5,227 units. NHF President Herbst estimates that by the end of 1998, 6,600 units will have been financed with NHF credits.

HUDA's strategy document foresees the NHF and TBS playing major roles in strengthening the housing sector in the near term. Already the program is generally considered a success and is in a period- of rapid expansion. It has elicited significant initiative, particularly from gminas and co-ops, to develop additional rental housing. It has also brought into play significant resources from would-be residents, both in the form of up-front payments and in the form of rents that are at least twice the level in most gmina-owned units. On the other hand, the majority of TBS are wholly gmina-owned, and to-date have not benefited from an infusion of private capital.

HUDA has proposed a large number of improvements to the TBS program which, as a whole, the team considers very sound. However, it is our view that it is also a good time to pose some additional and difficult questions, especially those with a longer-term horizon. Our concern is that the program mature with a solid financial and management structure. The salient questions include:

- How well is the TBS management infrastructure developing and to what extent are their goals being met?

- What income groups are being served and at what cost? Is this the best programmatic approach and the best use of public funds to meet the housing needs of middle income families? Or should alternatives such as one-time new homeowner grants also be introduced?

- Are there ways that the system can garner more equity participation from the private sector? Can it better contribute to movement towards market-based rentals drawing primarily upon private capital and management?

- Finally, are there any significant long-term hazards in the workings of the system, especially as it moves towards large scale operation?

These cautionary queries are based upon extensive experience (some very negative) in the U.S. and Western European countries with subsidized rental-production programs. In these U.S. and other programs, there has been a pattern of introducing a financing package that proves to be very popular, but flaws are then found in other aspects of these programs. These flaws can be remedied, but (as evidenced by certain U.S. programs) can also be extremely costly if the program has made extensive commitments before critical evaluations are done. Similar flaws, if they were to occur in Poland, could also undermine the potential for the National Housing Fund to tap into private funding without a state guarantee.

Recommendation

Our overall recommendation is that HUDA and BGK be supported in their proposed efforts to expand and improve the NHF/TBS system. However, due to the unexpected and major tasks involved in handling credits for the flood program, the NHF is just developing its portfolio monitoring system. They have recently reorganized, establishing a financial monitoring unit through British Know-How Fund assistance which will expand their efforts to include performance monitoring in their evolving computer system. Program design is being aided by a committee of users consisting of representatives of BGK departments. Monitoring should facilitate better tracking and assemblage of data on the TBS, rental housing products and their tenants which currently does not exist in any consolidated form (to our knowledge) and is essential for loan portfolio and overall program management. To improve information concerning the nature of TBS and characteristics of areas in which TBSs are evolving, the BGK is commissioning a market research firm to survey existing TBS and the officials of the gmina.

Our general caveat is that Poland should not hastily let expanding the number of units under production take precedence over securing long-term financial planning, monitoring, and management. Without these activities, the hoped-for participation of the private sector, and even the ability of BGK to raise funds in the capital market, will be threatened. These concerns lead to some additional suggestions for technical assistance, noted under "Additional Recommendations" below.

Key to attracting private sector financing are good lending practices and adequate monitoring and supervision of loans and borrowers. Although HUDA registers the TBS, they do not review the financial status of the TBS and have no plans for organizational monitoring. A long unresolved issue is the lack of de-registration procedures for TBS which do not comply with statutory responsibilities or violate other regulations. A similar issue centers around the need to clarify BGK procedures to address potential loan default and TBS bankruptcy.

Finally, as the NHF system is financing long-term projects developed and managed for the most part by inexperienced new organizations, it is crucial that the loans and borrowing organizations be carefully monitored in order for the NHF to be attractive to private capital, as envisioned in its initial development. Good monitoring facilitates understanding of the demand for various types of rental and other types of housing products and the clients served.

HUDA's Proposed Improvements

As noted, the first step is for the NHF to continue its efforts to finalize loan and organizational performance monitoring. This is essential for good loan management, obtaining private funding for capitalization, and for monitoring the program from a policy perspective. Absent clear information as to the costs and affordability of housing products and the income levels of clients served, it is difficult to measure program success or determine incremental changes for program improvement. *Question: Should new projects be slightly delayed until the monitoring system has had time to catch up?*

Actions that will lead to a stronger and more independent TBS sector should be supported. This includes training and technical assistance to this emerging sector and support of the Consultation Points to provide regional information and technical assistance bases. Assistance to strengthen TBS should reduce incidents of organizational failure. Attention should be paid to the issues of TBS deregulation and a process to cover defaults and housing management take-over. Without these provisions, the risk for private investors is greater. Finally, review of the program goals should be conducted in light of the various suggestions for more radical program modifications, such as selling rental units.

Additional Recommendations

- A second, but closely related, recommendation is that a critical analysis be made as to potential, long-term weaknesses in the program design. Experience throughout the U.S. and Western Europe suggests that there can be a thin line between a very successful program and a very costly failure.[11] One problem is that the very success of the program can imply a large scale of production that overwhelms the administrative infrastructure. Some of the other sources of such failure have included: too much reliance on, and not enough monitoring of, inexperienced development organizations and untested financial projections; unclear responsibilities in case of fraud or bankruptcy; indeterminate sources of financing for long-term rehabilitation; incentives for inefficient or corrupt management; unclear rules with respect to setting rents, treating delinquencies, and offering ownership; and so on. Now that a popular financial structure has been developed, it becomes more important to refine the model to make it more robust.

[11] See, for example, the recently-issued "Sustaining Non-Profit Housing Development", Washington, DC: Fannie Mae Foundation, 1998.

- The most effective TBS development has occurred in gminas with a strategic approach to defining and resolving their housing problems. Conversely, barriers to positive TBS development exist in gminas that have a poor understanding of their local housing systems and problems. And while national awareness has increased concerning the TBS, many TBS initiators cite a lack of awareness of the potential benefits of TBS or a distrust of the concept on the part of local officials as their major barrier to successful organization. This suggests that HUDA should strengthen efforts to assist with gmina-based public information campaigns on housing issues, problems and solutions. A constant problem cited is the lack of understanding of the TBS/NHF concepts or the real housing options. Clearly, this recommendation extends beyond addressing the NHF/TBS system to rent policy and housing strategies overall.

- Another related recommendation is that some consideration be made of how the NHF/TBS system can promote the movement towards reliance on private market provision of rental housing. In some ways, it is evolving towards a second tier of municipal rental housing, with rents far closer to full market cost, but still clearly below that. In the current NHF program, subsidies cover a significant portion of development costs. (The NHF financing can cover as much as 70 percent of the total cost. The subsidy conveyed by this financing, at one-half the "discount rate," is roughly 40 percent of the market interest rate, or about 28 percent of the total cost. In addition, a portion of the loan is then forgiven at the completion of the building, which is equal to about 10 percent of the total cost (not the loan). Thus since part of the loan (about 14 percent) is forgiven, the financing subsidy drops from 28 to 24 percent of total costs. With the loan forgiveness, however, the total cash value of the state subsidy is about 34 percent (24 percent plus the 10 percent of total cost). In addition, there may be contributions of land and infrastructure by the gminas, so that about one half of the total cost may be provided. Can an additional program be structured so that a third level conveys a shallower, more sustainable degree of subsidy, actually bringing rent levels closer to market levels? Are there ways to better integrate such systems with an income-tested housing allowance subsidy?

Technical Assistance

Considerable technical assistance is already being provided to the development of the NHF and the TBS sector by the European Union and the British Know-How Fund. However, a considerable portion of the funding may cease by year-end. It is proposed that assistance continue, including possibly assisting ongoing efforts as well as advising on lessons learned/long-term strategy to assure NHF and TBS sustainability.

- **A Review of Lessons Learned in Affordable Housing Schemes in the U.S. and Western Europe.** A review of best practices, costly mistakes, and relevant experience in the U.S. and Western Europe (and possibly other subsidized rental housing sectors in the region) could be very useful to illustrate issues, pitfalls, and strategies for long-term sustainability of management, maintenance, capital repair, and so forth. Our key recommendation is that continuing problems in other countries prove that long-term issues deserve considerable attention. Furthermore, in the rush to gain momentum for a new program, TA has focused mainly on the "micro" issues of individual TBS or monitoring data points; however, a "macro" and long-term look has not yet been undertaken.

- **Continue TBS Technical Assistance and Build TA Capacity in Local Organizations.** Training and technical assistance directly to TBS, with an emphasis on building capacity in the Consultation Point gminas or other local organizations which can then increasingly undertake this type of assistance, should continue to be supported. The NHF, in conjunction with the TBS Forum, has devised a system of consultation points through those mature and successful TBS which have experience to share with those in formation. Initially, the BGK was to provide financial support to the six or seven TBS that provide consultation and training services; however, funding has not been forthcoming to date. This also might includes continued access to the IREM management training (offered through the Polish Real Estate Federation), general business management and business planning, real estate finance, project development planning and overall community development training.

- **Pilot projects in LGPP Gminas to use the TBS as a Manager for Renovation.** As was noted in the overview, present policies for rehabilitation do not seem adequate in the face of the magnitude of the problem. While there is USAID and other donor activity in rehab as well as TBS, and pilot projects are being planned, our proposed pilot would test using the TBS as one type of institutional model for stock renovation. We also support using NHF funding for renovation (as was permitted in mid-1997). Among the TBS who are management agents as well as developers, there are already a number of success stories. Also, a number of gminas are already involving their TBS in aspects of renovation. Thus, the components of successful strategies could be combined to focus on TBS as management agent for renovation. Importantly, this avoids the gmina having to form an alternative management structure for rehab. In addition, experienced TBS may be (or become) adept at involving tenants in decision processes.

■ **The Role of Subsidized Rental Housing in Housing Sector Strategy and Increased Private Sector Involvement.** Several related efforts are important here. Among other efforts, the British Know-How Fund (BKHF) is assisting BGK structure an approach to obtaining funding from the Polish and/or international capital markets. HUDA and BGK could be assisted in formulating long-term options for making the NHF/TBS system as supportive and consistent as possible with eventual privatization of the (rent-controlled) rental housing sector. As we proposed in the discussion of rent reform, rents (in remaining rent-controlled housing) should ultimately aim to be closer to market levels (above 3 percent of replacement costs); TBS rents must also provide sustainable returns. A related issue is the so-called investment index—a cost index more suited to the investment costs facing the TBS; while this should be devised internally (by GUS, for example) assistance could be offered in its design (this was suggested by BGK). Finally, related issues are whether TBS units should be sold, and whether alternative strategies for assisting means-tested home ownership should be developed, such as offering grants to first time homeowners).

6. INCREASING PRIVATE RESOURCES FOR HOUSING LENDING

Contract Savings Systems

The government has passed laws facilitating the creation and operation of two contract savings schemes. The first, *kasy mieszkanove* is in operation and the second, the *Bausparkassen* system is slated to begin operations by the end of the year. The purpose of these programs is to create a pool of long term savings dedicated to housing. A USAID-supported study in March 1998 recommended a number of changes in the *Bausparkassen* Act to facilitate a safe and sound operation at sustainable levels of government budgetary support. The Ministry of Finance (MOF) has prepared a number of amendments to the Act (draft of June 8, 1998) that are consistent with the recommendations of the study.

Issues and Options

The proposed amendments go a long way towards improving the safety and soundness of the system. There remains, however, an inconsistency regarding the subsidy. The MOF proposes to leave the premium rate at 30 percent of annual savings but to cap the maximum annual premium at a level equal to the value of 2 square meters of housing (indexed to annual consumer price inflation). The cap will lower the annual budgetary obligation of the government and is consistent with reducing the burden of the program on the state budget. This change will also most likely lower the annual contract savings amount as many individuals will not save more than the amount subject to the premium because of the low savings interest rate. In effect this will result in greater use of Bauspar contracts and subsidies for renovation and modernization as the funds saved and borrowed will be too small to finance the construction or purchase of a house.

This result is inconsistent with the stated objective to help create conditions for larger savings for new housing. If the desired result is use of Bauspar funds for new construction and purchase, the current cap should be maintained but the subsidy should be reduced to 20 percent. The subsidy rate of 30 percent generates extraordinary returns for savers, though the stated role of the subsidy is to supplement the low savings interest rate up to the market level. For example the program generates a return equal to 4.2 percentage points over inflation for a seven year saving period and a return of 7.2 percentage points over inflation for the minimum four year savings period under current MOF inflation assumptions. Although current real savings rates range between 3 and 6 percent for terms between 1 month and 1 year, they are considered to be abnormally high, reflecting the impact of the Asian crisis on the Polish economy. The Polish government should not lock in a subsidy program that generates such high real returns over extended periods of time.

If the desired result is to provide resources for renovation and improvement then reducing the cap while maintaining the premium rate is appropriate. However, a three year minimum savings period may be more appropriate for this purpose. The choice of a minimum savings period is a trade-off between the safety of the system and its attractiveness to participants. A four year minimum savings period may reduce the attractiveness of the system to households mainly interested in renovation and improvement. If the subsidy is not overly attractive and, as the MOF recommends, the Bausparkassen have the right to impose longer waiting periods, a three year minimum period can in most circumstances be safe. It is important that the MOF and the NBP develop a simulation model capable of simulating the performance of the schemes in different macroeconomic environments in order to judge the safety and soundness of various parameters.

The MOF's proposed amendments include a provision to defer payment of the subsidy until the loan is taken out or the savings contract concluded. Their reasoning is that it is costly to issue bonds to fund payment of the subsidy to the Bausparkassen which in turn will invest in the bonds as assets during the start-up phase of the program (earning the spread between the Bauspar deposit rate and government bond rate). The deferral has been criticized by HUDA and others as adding an element of political uncertainty because it is not definite that the government will have the funds available when the saver completes the contract, which reduces the attractiveness of program. The MOF amendments propose that the Council of Ministers stipulate " . .. by way of an ordinance, . .. detailed principles of Bonus payments". It is essential that the details of payment be decided as soon as possible, that they be as transparent as possible (e.g., setting up individual bonus accounts in both the institution and HUDA), and that the obligation to fund the bonuses be recognized as a future budgetary obligation.

The Bausparkassen have criticized the proposal for a 3 percent technical reserve, stating that such a reserve would adversely affect the profitability of the institutions. These reserves can be invested in government securities so there does not appear to be any profitability impact of the reserve. Because the performance of the system will be difficult to project in its early years, a larger reserve (e.g., 10 percent) is preferable to ensure that there are sufficient funds to meet the initial loan demand. This reserve can be adjusted once the system approaches a steady state performance.

Recommendations

With regard to the subsidy, the GOP should decide whether the resources accumulated through this program are best allocated for renovation and modernization or for new construction and purchase. If the former is desired then the MOF's proposed amendments to the subsidy (lowering the cap and maintaining the subsidy rate) are appropriate. If the latter is desired then the current cap should be maintained (subject to changing the indexing formula) but a lower subsidy rate of 20 percent should be adopted. A focus on lower savings for renovation and modernization is more consistent with current Polish housing needs, as well as the government's priorities of developing private pensions and the mortgage bond market, given the likely performance of the contracts in an inflationary environment. As noted in the study, inflation reduces the attractiveness of the contracts, and the loans are only a supplementary source of finance in non-inflationary markets in France and Germany.

The amendments proposed by MOF do not suggest any changes in the *kasy mieszkaniowe* system. The level of subsidy in this system should be in line with the subsidy levels in the *Bausparkassen* system. Thus, a reduction in the subsidy rate or maximum for the *Bausparkassen* scheme should be accompanied by a reduction in the subsidy rate or maximum for the *kasy mieszkaniowe* scheme. As pointed out in the study, the presence of two potentially competing contract savings systems can undermine the stability of both. Therefore, strong consideration should be given to the merger of the two systems at a later date.

Technical Assistance

The government could be supported in the management of the contract savings systems in Poland in the development of a *Bausparkassen* simulation model that can quantify the potential liquidity risk of the institutions and through a study analyzing the issues and alternatives associated with the merger of the two systems. The simulation model can be developed as a variant of the mortgage bank simulation model. The model would construct a balance sheet of a *Bausparkassen* under assumptions about the magnitude of savings and loan demand in different macroeconomic environments (which impact the relatively attractiveness of the program). This model can be a tool for use by NBP in analyzing the risk of the system and by the MOF in forecasting future budgetary obligations. Although there is not a lot of political support for merger of the two systems today, it is almost certainly going to become an issue by the year 2000 when the *kasy mieszkanove* system is likely to need a short term loan from the National Housing Fund to meet expected loan demand. Perhaps this study could be part of a larger study of the funding needs and resources of the Housing Fund.

The Mortgage Fund

Recommendations

- **Background.** The Mortgage Fund was created to promote mortgage lending using the dual index mortgage (DIM) by providing long term refinancing for banks making DIM loans. Demand for the Mortgage Fund loans has been and continues to be weak. There are at least three reasons for the weak market acceptance of the Mortgage Fund: weak demand from banks reflecting their liquid condition and small mortgage portfolios. The relatively high cost of Mortgage Fund loans (relative to retail deposits) and the complexity of the loan and procedures to originate and refinance affecting both borrower and bank demand. It is doubtful that any new banks will enter the program given the uncertainty over its continuation beyond the end of the year. Only five banks have been active in the program (four currently) and the total volume of lending through 1997 was PLN 53.9 million.

- **Current Status.** The government would like to privatize the Mortgage Fund host, the Bud Bank. The Bud Bank would like to expand its retail operations to include mortgage lending (construction loans and permanent financing), as a mortgage bank. If Bud Bank commences retail mortgage lending or the Mortgage Fund is transferred to a host that engages in retail mortgage lending, such action would violate the terms of the farmer loan agreement between the Government of Poland and the World Bank. The treatment of the Mortgage Fund in the offer is unknown. The G-12 bank group has expressed an interest in the Mortgage Fund (and Bud Bank) as well. The IFC has recommended termination of the Fund and sale of its assets (either separately or as part of the Bud Bank privatization).

- **Recommendations presented in the HUDA strategy paper.** Accelerate the privatization of Bud-Bank and development of mortgage banks in Poland. Before deciding on Bud Bank privatization a decision must be made on future operations of the Mortgage Fund. There are several concepts of how it can be made a more helpful instrument to support development of the mortgage loan market and development of housing construction. Such concepts must provide for sufficient control over Mortgage Fund resources left with privatized Bud-Bank, or transfer the Fund to another bank (Bank for National Economy – BGK). Specifically, HUDA recommends developing [the] concept of operation of the Mortgage Fund in new conditions and making a decision on its location in the banking system and extension of operation of the National Housing Fund and the BGK.

Issues and Options

The retail mortgage market has developed considerably over the past few years. There are now more than 20 banks in Poland engaged in mortgage lending. There is no need for a government-owned bank engaged in retail mortgage lending (construction or permanent). Thus, the Bud Bank should be sold as soon as possible. The value of the Bud Bank could be enhanced if the government granted it a mortgage bank charter prior to sale/privatization. This action may necessitate an equity injection from the government depending on the National Bank of Poland’s minimum equity requirements for a mortgage bank. The sale of Bud Bank to a retail banking group engaged in mortgage lending or a resumption of retail mortgage lending by the Bud Bank as a government-owned bank would necessitate a change in the Mortgage Fund.

The IFC has recommended that ". . . any on-going Government liquidity facility for the housing sector not be connected to the present Mortgage Fund". Their rationale is that the Fund has not proved its viability, and that any liquidity facility would be temporary and provided through a government entity. Their concern is that the Fund would be difficult to discontinue in the future if it were a "formal government program" and/or a formal financial intermediary.

This recommendation ignores that fact that the Fund has advanced the development of the mortgage market in Poland, even without a large volume of lending and has developed a set of standardized documents and procedures, training support and analysis tools for DIM lending. Discontinuing the Fund and re-creating it in the NBP seems unnecessarily wasteful if there is still demand for remaining Fund resources. Furthermore, even if the Fund is sold, its current portfolio of assets and liabilities will need to be serviced by some entity.

In the opinion of the team there is an ongoing demand for DIM loans in the Polish economy. Contrary to the assertion of the IFC that " . . . these mortgages would likely be made to middle and upper income borrowers", in the current situation of high interest rates DIM loans (with a 1.2 percent first payment ratio) are almost twice as affordable as a classic loan with the same conditions (interest rate 26 percent, maturity 14.5 years, (e.g. PLN 100,000 loan—DIM payment 1,200 PLN/month, classic loan 2,219 PLN/month). USAID analysis of mortgage loans made from the mortgage fund show that a significant proportion went to below median income households.

If macroeconomic conditions improve and nominal interest rates fall, conventional loans will become more affordable to middle-income households but until that time there is a (transitional) role for a Fund refinancing DIM mortgages. The experience of the Fund suggests that these loans, while complex, can be successfully commercialized if there is a willingness to do so by lenders. There is an on-going demand for Fund resources from the two largest borrowers of the Fund, PBG and BISE, both of whom stated in interviews that they would cut back their DIM lending if the Fund is discontinued.

We believe that there are three principal options that HUDA and the GOP should consider with the Mortgage Fund:

- **Transfer within Government.** The Mortgage Fund can be separated from Bud Bank and transferred to another government entity (e.g., BGK, NBP) that would continue to operate the Fund. The Fund appears to have sufficient liquid assets and incoming cash to meet demand for the next two years at current levels of lending (approximately PLN 20 million annually). This option will maintain a competitive alternative to PKO-BP offering DIMs in the Polish market. Its small scale and independent financial status should make transfer relatively easy. This should only be done if the costs (e.g. system) are minimal and the host is agreeable. Under this scenario the Mortgage Fund would cease operations in 1-2 years (when its resources run out) and thus would serve a transitional role in providing long term resources until a viable mortgage bond market is developed. The government may wish to provide additional resources to the Fund if demand picks up, but such funding should be transitional and used solely for the purpose of refinancing deferred payment mortgages.

The creation of the G-12 mortgage bank could increase demand for Mortgage Fund loans by expanding its distribution network. One use of Fund resources could be to purchase the initial issues of G-12 mortgage bonds (particularly if backed by DIMs, as there would be little possibility of placing such bonds on the open market). To do so may necessitate a modification of the Fund charter to allow it to purchase residential mortgage bonds (from all mortgage banks).

- **Sale of Mortgage Fund Assets.** The Fund could be sold to a private entity either as a part of or separate from the Bud Bank privatization. From a commercial standpoint, operation of the Fund within a banking group in Poland is not viable as it is highly unlikely that it could continue a meaningful volume of lending to other banks if it were part of a Polish banking group.

In this scenario the Fund should be viewed as a government asset and not an on-going operation. The Fund's assets could be sold to another financial institution that would be required to service the loans until they were fully repaid. Proceeds from sale could be used for other government programs [note that the government is obligated to repay the World Bank and USAID loans so use of proceeds in this manner mainly affects the timing of programs]. Further research is needed regarding the future cash flows of Fund assets and liabilities before any conclusion can be reached about the advisability of sale (of the asset) versus liquidation. The small scale of the Fund, the necessity to continue servicing the loans, the continued deferral of loan cash flows and the complexity of the loans suggest that any buyer would discount the assets significantly. Care must be taken to safeguard information about participating bank customers that is possessed by the mortgage fund.[12] We do not think that operation of the Fund as a government-owned entity within a private group (e.g., the G-12 mortgage bank) is advisable. This would give the government an ownership share in a private entity (group).

■ **Privatization of Mortgage Fund.** Operation of the Fund as a stand-alone, privately owned entity (e.g., as a centralized liquidity facility like the CRH in France) appears problematic due to the weak demand for its products. As a privately-owned or stand-alone entity we would agree with the IFC assessment that the Fund is not viable. Creation of a government-owned centralized liquidity facility is also not advisable as it would create a competitor for mortgage banks with preferential funding possibilities.

The Mortgage Fund could not be turned into a mortgage bank without a change in the Mortgage Bank Act. This Act does not allow loans to other banks as collateral for mortgage bonds. Also, the legal status of such loans (loans collateralized by loans) is not clear. The Fund has insufficient equity at present to meet expected NBP requirements.

The equity of the Mortgage Fund could be used as seed capital for a mortgage bank. The Fund equity could be turned into shares owned by a government entity (e.g., BGK) forming part of the capital base of a mortgage bank (e.g., the G-12 mortgage bank). The rationale for this approach is to ensure that at least one mortgage bank focused on residential mortgage lending (a requirement for contribution).[13]

Market participants suggest that most of the initial mortgage bank lending will be in the form of hard currency loans for commercial real estate projects. The government's share should be less than 50 percent with plans to sell its stake over a medium term time horizon.[14]

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[12] Concern about access to this information by Bud Bank has been an inhibiting factor to bank participation and would be of even greater concern if Bud Bank were private or part of another banking group.

[13] It is unlikely that mortgage banks created under the new Act will make DIM loans. To do so they would have to be funded primarily from non-mortgage bond sources, as only the amount up to 60 percent Loan-to-Value ratio can be funded with mortgage bonds. The matching requirements may necessitate funding with indexed bonds that would be difficult sell in the current Polish market.

[14] The government initially owned all of Fannie Mae and the Federal Home Loan Banks which are now entirely private. There has been minority government ownership in several developing country secondary market institutions including Malaysia, Trinidad and Jordan. Partial government ownership is often seen as a preference and therefore may be resisted by purely private sector players. These concerns may be mitigated if the activities of the mortgage

Recommendations: Grant Bud Bank a mortgage bank license and sell it. The sale will provide additional revenues to the government, enhance the franchise value of the Bank and get the government out of the retail banking business. Transfer the Mortgage Fund to BGK or NBP if they are agreeable and the transition costs are minimal. This approach is preferable to terminating Fund lending and contributing the equity to a new private sector mortgage bank because it would keep a flow of funds dedicated to DIM lending in the market. The charter of the Fund should be amended to allow it to purchase mortgage bonds backed by DIMs and other deferred payment mortgages. UIC is currently conducting a study to identify the principal options available to the Polish government regarding the Mortgage Fund.

Technical Assistance

Technical assistance in the form of a study of the options for transfer, sale and or liquidation of the Mortgage Fund could be appropriate. This study would analyze the current balance sheet and cash flow forecast of the Fund under different assumptions about the demand for loans from participating banks and develop in detail the pros and cons of the three options (transfer, sale, privatization). This is an issue which is integral to the evolution of private sector housing finance in Poland.

Mortgage Banking and Mortgage Bonds

The Mortgage Bank Act was passed in 1997 to create institutions that specialize in lending for commercial and residential real estate and to local governments funded through the issuance of mortgage bonds. Since passage of the Act, there has been considerable activity developing implementation guidelines governing the regulation and supervision of mortgage banks and mortgage bonds.[15]

HUDA Recommendations

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bank were restricted to residential and communal (gmina) finance and the government announced that it planned to sell its shares within a certain time period.

[15] See for example Chiquier, L., *Regulation of Mortgage Banks and Mortgage Bonds in Poland*, USAID, June 1998. and Mortgage Credit Foundation, *Development of Terms and Conditions Concerning Implementation of the Act on Mortgage Bonds and Mortgage Banks,* April 1998. Also, as mentioned, a Mortgage Bank Simulation Model has been tailored to the mortgage bank structure proposed for Poland and has been made available to all counterparts in the UIC Housing Finance Project. Further improvements and adaptations are currently being made for NBP.

Despite a European Union directive recommending a solvency ratio of 50 percent for mortgage loans, the National Bank of Poland (NBP) does not consider mortgage bonds to be enhanced-quality securities. Thus NBP assigns a risk weight of 100 percent, which increases the issuer's costs and decreases mortgage bonds attractiveness for investors. Also, certain investors are not legally allowed to invest in mortgage bonds. [As a result] one can anticipate that, given the present circumstances, mortgage bonds will not be popular. HUDA recommends amending provisions in order to enable numerous financial market entities to invest in mortgage bonds and lowering the risk weight for mortgage bonds.

Issues and Options

Currently, residential mortgage loans carry a 100 percent risk weight due in part to the weakness of the lien. The loans backing mortgage bonds will be lower risk, conservatively underwritten loans, with a lien that has a higher priority than the statutory lien. The conservative underwriting and priority over the statutory lien suggest that the risk weight of the conservatively underwritten residential loans backing mortgage bonds should be lowered to 50 percent in line with EU solvency requirements for such mortgages.

The credit quality of mortgage bonds will be higher than mortgage loans in general as there will be some over-collateralization and backing by the equity of the issuing bank. Mortgage bonds in the EU generally carry a risk weight of 20 percent in line with EU solvency requirements for inter-bank debt. The Mortgage Foundation has proposed lowering the risk weight of mortgage bonds in Poland to 10 percent

The protections inherent in the mortgage bond Act suggest that a risk weight comparable to interbank debt is reasonable. Currently, the risk weight for interbank debt in Poland is 30 percent for Polish banks and 20 percent for OECD banks. However, a lower risk weight is not justified in Poland given the nascent state of the mortgage and mortgage bond markets. As the market and mortgage banks are not yet operation there will be no disturbance in the economy by having a higher risk weight.

Currently, mortgage bonds are not legal investments for insurance companies and their eligibility as legal investments for other institutional investors is unclear. The Mortgage Foundation’s Implementation Report (4/8/98) recommends adding mortgage bonds as eligible investments for insurance funds, pension funds, investment funds, co-operative savings and loan institutions, contract savings institutions and BGK. The design of the bonds and the banks puts great emphasis on their safety. The mortgage bonds therefore should be eligible investments for insurance companies and other official institutional investors.

Recommendation

Support a lower risk weight for mortgage bonds (to a minimum of 20 percent) and the inclusion of mortgage bonds as eligible investments for insurance companies and other institutional investors.

Technical Assistance

USAID should continue development of the mortgage bank model for use by NBP and the banks. The model's capabilities need to be expanded to include an interface to make it more accessible for new users, development of a module for commercial real estate loans (which are larger and should be handled on a discrete as opposed to pool basis) and expansion of the model's asset and liability classifications so that it can emulate a universal bank. The model can be used to simulate the effects of different mortgage instruments that can be adopted in a lower inflation environment. The fixed rate module should be expanded to include graduated payment mortgages and both the fixed and variable rate mortgages to include interest rate buy-downs. An expanded model can be used in training and to help policy makers with still to be resolved questions about the capitalization, risk weighting and matching requirements of the mortgage banks.

7. MAXIMUM UTILIZATION OF THE EXISTING HOUSING STOCK

Rehabilitation

The need for renovation of various housing stock types in varying stages of deterioration has long been a policy concern in Poland. The policy initiatives and the legislative debates, however, have not yet produced programs which even begin to measure up to the problem. There are multiple problems, for one thing: renovation of individual units; individual buildings; so-called complex renovation, which includes major urban renewal and historic preservation as well; and finally, thermal renovation. In addition, estimates of how much various initiatives cost, and who should pay, is complicated by the complex—and apparently extremely large—legacy of the capital repairs backlog. This backlog, in particular, sets in motion equity issues and pricing problems: for example, why should owners of newly-privatized (communal) housing pay for building renovation when their counterparts still in communal housing would be supported with gmina or state funds? One answer is that the unit was likely privatized at a great discount, in part, because of the backlog; on the other hand, will gminas who renovate their buildings be able to privatize them at a price which would capture the renovation cost? The renovation challenge in older stock is further complicated by the mixed ownership of much of the stock in the form of *wspolnotas* (housing associations), which have not been able to obtain agreement from their members on financing of major building repairs (as opposed to those in individual units).

As noted above, in the team's view, rehabilitation policies are associated with, or driven by, nearly all the elements of the policy framework: increased rents; the likelihood of increased privatization as a result of increased rents; the depth of the privatization discount in rehabilitated and non-rehabilitated buildings; the rationalization of the ownership structure in privatized buildings in order to better garner private resources to share in rehabilitation costs; and not least, a recognition by the state that the capital repairs backlog is a national legacy which the central government must share in redressing.

Estimates of Poland's renovation needs and projected costs range considerably. Data provided by HUDA state that according to 1995 estimates, approximately 7.3 million units require renovation, of which 1.1 million require capital rehabilitation, 1.3 million renovation and preventive work and the rest require only moderate renovation and conservation. The estimated cost for this work is PLN 30,000,000,000[16] or U.S. $9 billion. A recent report by the Housing Research Institute drawing on recent analyses of Poland's housing conditions provides further descriptive information on the renovation needs and the following cost projection:

- The renovation gap is estimated to be at a level equivalent to the construction costs of approximately 750,000 dwellings- a figure considerably higher than that projected by HUDA. As little as a third of this required amount is being spent for renovation purposes in Poland.[17]

[16] Data taken from the Concept paper on the Renovation Fund, HUDA. Estimate is based on 30 percent of potential needs in 3.5 million apartments based on an average cost of PLN 30,000.

[17] J. Kornilowicz, Hanna Kulesza. *Assessment of Building Renovation Requirements in Polish Cities.* (Housing Research Institute).*Urban Construction and Economy*, vol. 7-8/1996.

- Every third dwelling is located in a building 50 years or older. Given insufficient maintenance over time, many of these buildings are nearly completely depreciated.

- According to GUS data, only 1.4 million dwellings were renovated after 1970, or 12.3 percent of the total dwellings in Poland. More frequent renovations occurred in older buildings.

- Between 1971 and 1995 only 11 percent of dwellings located in municipal buildings were thoroughly renovated. According to the Housing Research Institute's 1997 research, 50 percent of Polish gminas did not allocate funds to renovate municipal buildings.[18]

- According to estimates, by the year 2010, 1.0 million dwellings or 10 percent of the total existing stock should be demolished.[19]

On the type of households occupying the units,

- Sub-standard apartments in older buildings are more frequently occupied by elderly households: 20 percent of pensioner households lack bathrooms and 46 percent live in dwellings without any gas or central heating.

- In urban households with an income below the poverty line, the average floor area per capita is 13.3 square meters and only 73 percent of such households live in the apartments equipped with basic facilities. In households above the poverty line, the respective ratios are 19.1 square meter per person and 91 percent living in the flats with running water, toilet and bathroom.

Surprisingly, in the face of this problem, there are currently no major national programs to address this complex problem. The efforts of the current HUDA administration to address this growing problem will thus be filling a major gap. An important element of any approach is to stimulate private investment in renovation of the housing stock wherever possible; however, the low income level of a good portion of owners and residents dictates that they will require financial assistance. The Housing Research Institute and other researchers cited above concluded that the renovation

[18] op.cit.

[19] "The estimate of the likely reduction in the number of dwellings occurring due to deterioration between 1994 and 2010." (IGM).Housing Issues vol. 2/1995.

backlog is so huge that it is unlikely that building owners and managers will be able to catch up using only their own resources.

Over the past eight years, one of the few tools supporting renovation was very modest tax relief for the renovation of apartments and a slightly more generous allowance for building common areas.[20] This provides minimal assistance, especially given the magnitude of the problem. Little of the renovation stimulated by this type of tax relief addresses major building systems and building-wide deterioration—a problem of much greater urgency.

Other assistance may now be offered through the NHF following changes in its ordinance in mid 1997 to allow credits to be granted to cooperatives or TBS for renovation of rental housing stock. The contract savings systems also provide a mechanism for owners to save and later borrow to finance renovation. However, both of these systems are new and, in the case of the NHF credits, limited in their application.

The major focus of local government lobbying for state assistance to renovation over the past three years was the proposed Act on Renovation and Modernization of Urban Buildings, designed to provide a shared state and local financing mechanism, organizational structure, and process for complex renovation and revitalization of carefully selected urban areas.[21] A complex approach is sorely needed in many urban areas with deteriorated and inappropriately used historic downtowns. However, the proposals contained in the Act were controversial, considered by some to be too prescriptive, too complex and too centralized. Negotiations over two years, however, were thought to bring divergent positions to a compromise. However, the Ministry of Finance has indicated that the financial obligations on the State budget would be too great.[22] Thus, the Act was withdrawn, considered infeasible in the current financial climate. This issues is addressed in the HUDA strategy (II.1.12) but it is unclear as to whether a

[20] Current tax relief for rehabilitation of common areas is .5 percent higher than for apartment renovation (2.5 percent vs. 3 percent of the price of a 70 square meter flat, or roughly PLN 3,000). But only one type of tax relief can be taken. It has been recommended to the Ministry of Finance to allow both, as the “one only” tax relief benefit limit acts as a disincentive for building repair.

[21] A detailed description of this Act is contained in *Building on Progress, The Future of Housing Finance in Poland,* Urban Institute Consortium, May 1997.

[22] Proposed State funding for 10 year program in million PLN: yr. 1: 33, yr. 2: 74, yr. 3: 111, yr. 4: 148, yrs. 5-10: 185.

new Act will be drafted or the previous draft presented (without the financial component?).

Parliamentarians involved in the issue have indicated their preference to first address other issues crucial to complex renovation strategies before reconsidering the Act. They recommend that greater support for historic preservation of landmarks be included in the Act on the Protection of Cultural Buildings before moving to pass an Act on Renovation and Modernization of Urban Buildings. Many buildings and targeted areas in older cities have some type of historic designation; this designation currently results in arduous preservation and conservation restrictions. However, the Ministry of Culture has few funds to support historic preservation, leaving owners strapped with stringent conservation conditions that may prevent them from upgrading or, in some cases, from using their property commercially. Resolution of the renovation problems presented by stringent conservation requirements without accompanying financial assistance is essential. This is proposed generally in HUDA’s Strategy Section III.1.3, which suggests a range of management improvements, clarification of ownership issues and sources of financing for building rehabilitation.

The concept of the complex renovation strategy emerged from local governments, which in the early 1990’s, began grappling with the challenge of urban revitalization. Relying solely on local budgetary funds and private investment leveraged from local citizens and other investors, several cities have developed successful multi-faceted renovation programs. They are testing the varied tools of grants and preferential credits to enlist owner participation and equity in building-wide renovation. As HUDA contemplates financial tools to support renovation, they should look to these local programs for tools that are being used successfully, and are efficient and sustainable.[23] Again, in the area of financial incentives for *wspolnotas*, a variety of financing options have been developed by local governments and should be monitored for their ability to leverage private investment and cost effectiveness.[24]

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[23] For example, Szczecin’s program is multi-faceted, with renovation financed with funds from the gmina budget, public/private partnerships through the TBS system and with private developers, and grant incentives for owner investment in common areas and energy efficiency programs. P»ock, Bielsko Biala, and Lublin and have commenced old town revitalization programs using a variety of different financing and organizational mechanisms.

[24] Sopot and Gdynia have organized loan programs for building wide renovation by wspolnotas through private banks with the cities paying all or portions of the interest on 3 to 5 year credits, other cities are providing grants upon completion of targeted building wide renovation.

Recommendations

- The most significant element of the HUDA strategy (III.3.4) for renovation is a new proposed Renovation Credit System which offers up to 10 year preferential credits through commercial banks for building wide renovation of predominantly residential buildings. The credit will be available to housing condominiums, private owners, gminas, and other legal entities. The credit will be provided at a preferential rate that is subsidized by tax exemption for banks' earnings from the renovation loan portfolio (if maximum interest rates are kept below a specified level). The second subsidy would be provided to participating banks through the NHF from State funds. Private owners will be further encouraged to upgrade their rental properties by a decrease in the rate at which rental income is taxed (from 40 to 20 percent). However, the Renovation system was stated by all the persons interviewed by the team to be "only in a conceptual stage". There are no projections of potential demand or projected cost. In any event, the "concept" should be explored further, including with banks and local governments. It also needs to be made consistent with the NHF funding for rehabilitation.

- The HUDA Strategy (III.3.2) suggests a modification of tax relief for renovation, increasing the levels of allowable deductions; however, HUDA indicated that this will not occur until the year 2000. Absent any new revision, HUDA could push for the possibility for owners to take both the deduction for apartment rehabilitation and the slightly higher deduction for building wide renovation rather than deciding between the two. This will remove the current disincentive for participation in building-wide renovation.

- There remain legal and organizational barriers to renovation strategies particularly complex revitalization; many of these could be addressed in a new renovation law, but some require other State and local government actions. These issues are identified in the HUDA strategy (II.1.12 and III.1.3); these suggestions should be carried out to allow local governments to use all potential tools in designing renovation assistance programs and strategies to best address their local needs. Others, such as the barrier to grant provision, require changes in the Public Finance Law.

- Introduction of legislation to support complex revitalization (II.1.12) was discussed above. Some who favor this Act suggest that without the financing component it is rather unnecessary. Others recommended the creation of regional funds rather than one national fund, given the current administrative reorganization that will establish larger, stronger voivodships. A variety of assistance tools—grants, preferential credits and tax relief—are perceived as necessary to support complex renovation. Thus, this Act should be revisited in the medium-term framework of HUDA's overall strategy.

Technical Assistance

USAID is already involved in a variety of technical assistance activities in rehabilitation, including through LGPP, CHF, and the Rehab Forum. There are also a number of gmina-based pilot projects underway or in planning. Some further suggestions for pilot projects are noted below; the gmina-based assistance should certainly continue to be supported since local initiatives (rather than centrally-funded assistance) have been, by far, the most important to date.

However, Poland also needs to finalize the development of its state-supported policies. It is our opinion that as soon as possible, a more significant amount of central government funds should be made available to address the rehab problem. It would be beneficial to combine the gmina-based successes with national funding strategies, which can both assist gminas with communal stock and elicit maximum contribution of owner resources in private buildings. We, therefore, propose a two-pronged approach which combines gmina pilot projects with further development by HUDA and others of national priorities with regard to the various types of renovation (that is, major building systems, urban renewal, and so forth) and the funding strategies appropriate to cost-sharing by the state, gminas, and owners. In addition, as has been discussed, at least some of the gmina pilots might test a number of elements of "overall housing strategy"—combining rehabilitation, rent increases, improved support from housing allowances, and a more functional ownership structure in privatized buildings .

Technical assistance recommendations include the following:

- **Further Development of State-Funded Policies for Financing Renovation.** As noted above, all persons interviewed by the team indicated that the Renovation Credit system is simply a "concept" at this time. However, some approach should be developed as quickly as possible. For example, HUDA, should continue its efforts with regard to the following types of issues:

— A national rehabilitation assistance program which better defines which problems are priorities, and the probable costs.

— Funding approaches consistent with funding from NHF (if NHF to be used for this purpose).

— Cost-sharing formulas with gminas and owners.

— Means-tested approach to elicit “fair” contributions from tenants and owners.

— Privatization policies whereby gminas can better mandate the ownership structure—and therefore the responsibility structure—for privatized buildings.

— Comparison of alternative funding approaches with regard to cost, administrative complexity, equity: for example, a grants system, a block grant strategy, preferential credits, and tax breaks.

- **Gmina Pilot Project in “Overall Housing Strategy.”** As discussed above, the problems associated with renovation are linked to numerous other aspects of housing strategy: rent increases, housing allowances to support rent increases, privatization policies and discounts, and condominium ownership and management structure. Section 1 proposes a pilot project (possibly in a voivod or powiat) combining rent increases with increased housing allowances. In addition, another “pilot” layer to this program would be a gmina within the powiat willing to test renovation strategies.

- **TBS-Managed Renovation Pilot Projects and/or Other Pilot Projects.** USAID and a gmina partner might utilize a TBS that focuses on management of existing stock to undertake a rehab pilot. TBS management would move the gmina away from direct provision of supervisory services. The TBS may also be able to use its new construction program as one form of replacement housing. There are also many other issues that need to be tested:

— Relocation strategies or renovation processes with tenants in place.

— Various financing mechanisms: preferential loans, grants, means-tested funding.

— Good management practice and tenant involvement in management.

— Pilot projects with wspolnotas for rehabilitation planning, financing and rent restructuring.

- **Analysis of Gmina Best Practice in Renovation.** As stated above, local governments now provide good examples of various programmatic approaches. HUDA should review the successful cases (looking for cost-effectiveness and sustainability) and analyze the impact of various forms of subsidies. USAID could provide assistance in both the review of national proposals and the existing local programs to discern optimal methods to encourage renovation in various types of housing stock with different ownership structure. Examples of successful renovation programs addressing similar issues (from the US, Europe and the region) could also be undertaken.

- **Public Education and Private Sector Participation.** The rhetoric in the HUDA Strategy is appropriate: "changing the perception of an apartment from a personal asset to a marketable commodity". There is much to be gained from devoting resources to a public education campaign on the current housing policy and tools and options available to both local governments and individuals. USAID may wish to assist in conducting community planning workshops and strategy sessions with gminas, local businesses, banks, housing providers, others in the real estate sector, and NGOs to define community development problems, strategies and tools.

Housing Associations (Wspolnotas), Privatization, and Rehabilitation

The privatization policy of selling communal housing units to sitting tenants was carried out by many local governments beginning even prior to the transition in 1989. This practice intensified in the early 1990's, resulting in the emergence of many mixed ownership buildings. Practices and policies vary from city to city but generally, units were sold for well below their market value, usually with no provisions regarding building condition, a renovation plan, or requirements that purchasers be financially capable of maintaining the building. The tendency was to purchase the most desirable units; however, throughout the country owners with limited means purchased units in buildings requiring considerable capital investment.

The passage of the Law on Housing Unit Ownership formally established the housing association and indicated the responsibilities of owners in maintaining the building common areas. As many owners felt no responsibility for building conditions resulting from decades of neglect, there was considerable protest over this newly legislated responsibility. Implementation of the Act over the past four years has revealed flaws in the legislation, some that have been corrected in earlier amendments, others that are proposed in the present HUDA strategy. In addition to problems of legal status, barriers to successful association development include: lack of financial support for rehabilitation, lack of management experience on the part of owners, unrealistic organizational and reporting requirements for privately managed associations, and limited enforcement of laws and regulations that should assist owners in carrying out building management.

Privatization and Rent Reform

In addition, future privatization should be considered in conjunction with rent reform and rehabilitation policies. As rents are increased, it is likely that an increasing number of tenants may wish to buy their units. Two factors, drawn from successful practices by the gminas, should be more broadly encouraged:

- To ease building management problems, gminas should give serious consideration to allowing tenants to buy their units only when a majority of tenants in the building agree to do so. By this means, more buildings will be managed by condominiums run by tenants, not gminas;

- Further, whether or not the policy of deep discounts is continued, it may prove unwise to privatize units to households with very limited means. This is, of course, a policy decision to be taken by the gminas, but if there is not a means test imposed for purchasers, gminas should consider their options for financing rehabilitation of buildings that are an integral part of the stock.

HUDA Recommendations

The HUDA strategy recognizes the barriers to successful association development noting that, legal issues, ownership issues, and cumbersome or costly bureaucratic procedures affect the ability of mixed ownership condominiums to manage themselves efficiently, or to organize for building-wide renovation, and to access financing. Point II.1.6 of the Strategy suggests remedies, including public education and training campaigns and modifying the Local Government and Budget Laws to allow gminas to provide grants to condominiums for building-wide renovation. Many local governments have created financial incentives for wspolnotas to begin building wide renovation providing a variety of financing options, including some that are currently illegal under present law.[25] This modification is necessary to allow for the use of grants, which are often less expensive than subsidizing interest rates.

The HUDA strategy cites the need for correction of legal and regulatory frameworks that would address problems faced by many condominiums: unclear interest in common areas, need to change plot boundaries, improved building code enforcement, and improved owner and minority shareholder protections. Yet, there are no specific recommendations how these improvements would be made. Also, there is a suggestion to simplify accounting and reporting procedures which are too cumbersome for condominiums, but again with no specific details (II.1.6 and III.1.3). All of these recommendations would assist the condominiums and implementation strategies should be sought.

The HUDA strategy recognizes the frequent inefficiencies of privatization policies of scatter unit privatization to sitting tenants with no income tests or renovation plans. Rationalization of the privatization policies to limit mixed ownership buildings and sale to those with sufficient income would be ideal for future privatization, but would not correct weaknesses in past privatization policies. While difficult politically, facilitating unit exchanges to create fully privately owned buildings or to provide housing options to owners too poor to participate in building renovation would greatly reduce many problems in condominiums (II.3.4). Many condominiums find that they may be hindered in renovation efforts by one or more low income owners who cannot participate in increased payments to rehabilitation funds or to pay off loans. Some attention should be given to how to assist these persons to pay their share of costs or to relocate them. Finally, the rhetoric in the strategy is good on this point of “changing perception of an apartment from a personal asset to marketable commodity”. There is much to be gained from devoting resources to a public education campaign on the current housing policy and tools and options available both to local governments and individuals.

Technical Assistance

[25] Sopot and Gdynia have organized loan programs for building-wide renovation by wspolnotas through private banks, with the cities paying all or portions of the interest on 3 to 5 year credits; Szczecin and some other cities are providing grants upon completion of targeted building wide renovation.

As noted at the beginning of Section 7, USAID is already addressing rehabilitation and ownership issues through several of its programs. Supplementary suggestions include:

- **CEE Review of Condominium Policies and Rehabilitation Strategies.** HUDA has proposed a number of salient strategies. It is desirable for further thought to be given as to how best to support the cooperation of residents in condominiums to meet the social and economic challenges of organizing and financing the long-term maintenance and rehabilitation of the buildings. Many of the other Central European countries are dealing with condominium issues and it would be useful to provide an opportunity for sharing and comparing of existing and proposed strategies. For example, a major program for condominium associations and condominium rehabilitation is being carried out by USAID in Hungary.

- **Public information and training campaigns are essential.** The lack of understanding of the responsibilities of condominium ownership and options for condominium management greatly hinder improvements in overall maintenance and improvement of the mixed ownership stock. Most condominiums are still managed by gmina management companies. The lack of full legal status of the condominium is partly due to this lack of trust for shared ownership and management of buildings. The perception is that a weak condominium cannot infringe on ownership rights. And, due to the lack of enforcement of building regulations and ownership infringements, condominium boards have little recourse in addressing owner violations of building codes, common space usage, or payment of fees and charges. One negligent owner can put the entire condominium at risk. Thus, there is a preference for individual loan agreements, and, while cumbersome, some banks are providing these types of loans. Increased public information, including examples of successful condominiums could lead to changes in these areas.

Social Housing

The Polish system of welfare benefits and housing allowances is now assisting many families and individuals to afford their housing units. However, as in every country, some households fall through the safety net of government assistance.

Some of these homeless are in need of housing only. However, many need special support to achieve independence. A large number of

Poland's homeless, probably the majority, suffer from alcoholism, mental illness, drug addiction, physical illness, abuse, or have poor coping skills. Support for these individuals and families should tie housing assistance to these multiple contributory causes that appear to underlie most homelessness.

Much of the information available on the homeless (and those on the brink of homelessness) is anecdotal. There is, as yet, no comprehensive system in place to assess the scale of the problem at the State, voivod, or gmina level. The statistics available vary greatly according to the agency or organization providing the information and on how the information was collected. Estimates vary from 20,000 to 400,000 homeless individuals in Poland. Most groups tend to agree that the true number is likely between 80,000 and 200,000.

Recommendations

■ **Adopting a Comprehensive Approach.** In many, perhaps most cases, homelessness is a social problem and not necessarily a housing supply problem. HUDA's goal of reducing homelessness can be reached only by assuring a comprehensive range of services to the homeless to help them on the road to self-sufficiency. To do this, assistance in making up for skill deficits, in overcoming mental and physical disabilities, alcoholism and drug dependencies and strengthening family support must be available in addition to providing adequate temporary or permanent shelter. Without rehabilitative and support services the social conditions which contributed to homelessness in the first place will continue, making real progress towards breaking the cycle of homelessness almost impossible. HUDA's primary role may be to coordinate provision of housing allowances with those institutions responsible for other aspects of the problem.

■ **Achieving Maximum Use of Available Housing Stock.** Although suggested by HUDA, a change in the building codes to allow the construction of substandard housing for the homeless is not recommended by the UIC team. Adding new units for the poorest (or non-functioning) households is not an efficient or cost-effective way in which to increase supply. Certain types of collective living arrangements, as mentioned in the strategy report, may be used by some housing populations with special needs or for temporary or interim housing. Housing stock for the homeless is allocated at the gmina level; HUDA's recommendation of using gmina housing as social housing seems reasonable. It appears, from the anecdotal evidence, that existing stock is often being underutilized for this purpose either because of a need for renovation or because of a flawed system of distribution in the gminas. Before building new social housing, it is important to assess the availability and condition of existing housing and the feasibility of turning it into special needs housing if that is required.

■ **Understanding the Scale of the Problem.** Because so much is unknown about the scale of the homelessness problem, HUDA would be well-served to keep its strategy open, evolving and flexible until a formal needs assessment can be performed to guide its long-term internal planning efforts. A substantial part of this needs assessment should take into consideration the proposed changes in the housing allowance formula and a toughening up of the housing enforcement regulations (particularly evictions) as both could have significant long term impacts on the number and type of homeless in need of assistance.

■ **Planning for the Long Term.** HUDA's plans for decreasing homelessness are very ambitious and the deadline they have set for accomplishing their tasks (by the end of 1999) is very tight. Loosening up that timeline by extending it for several more years may help HUDA to be more successful in the long run.

Technical Assistance

Because the U.S. has struggled for many years with the problems of its own homeless population, extensive experience exists in understanding the problem, measuring the problem, and proposing modalities of assistance which are relevant to the different problems involved. Thus, USAID could offer HUDA the following types of technical assistance:

•Assistance with the methodologies developed over many years in the U.S. for estimating the current number of homeless in Poland, the reason for their homelessness, and the probable impact of proposed State initiatives.

•Assistance with development of gmina-level education programs—again based on lessons learned in the U.S.—to promote awareness of the problem and to suggest appropriate solutions to homeless problems in their communities.

•Development of a pilot project in a chosen gmina or voivod to demonstrate an integrated approach to solving homelessness. This might include, for example, working with NGOs and halfway houses for the treatment of homeless alcoholics who will eventually be mainstreamed back into the community.